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INVESTIGATIONS

ACCOUNTANCY AND FINANCIAL

BY

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"LOANS AND BORROWING POWERS OF LOCAL AUTHORITIES,"
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PREFACE

INVESTIGATION work is probably the most difficult section of an accountant's business activities—and it is probably the most interesting. Just as every accountant is not fitted to be an auditor, so every successful auditor is not suited to be an investigator.

It has been said that poets are born—not made ; and it would be equally appropriate to substitute “auditors” or “investigators” as the substantive of the phrase.

Everyone cannot, however, choose his natural qualifications, and so if one is expected or desires to try to perform tasks better suited to others, one's plan should be to equip oneself for the work as well as possible.

The observations in the present book are tendered in the hope that they may be helpful to those in the latter category.

J. H. B.

CONTENTS

	PAGE
PREFACE	V
CHAPTER I	
MEANING, SCOPE, AND OBJECTS OF INVESTIGATIONS	I
Meaning of investigation—Objects of an investigation— Extent of an investigation—Limits of an investigation	
CHAPTER II	
QUALIFICATIONS OF AN INVESTIGATING AC- COUNTANT	7
Attributes of an accountant—Knowledge of men and their ways—Tact—Patience—Self-possession—Percep- tion—Quick-thinking—Humour—Literary ability— Character—Personality	
CHAPTER III	
STARTING POINTS OF INVESTIGATIONS . . .	14
Discovering the reason—Ascertaining the character of persons concerned	
CHAPTER IV	
THE ACQUISITION OF AN UNDERTAKING . . .	16
Profit not understated—Methods of falsification—Falsi- fied balance sheets—Falsified revenue accounts	
CHAPTER V	
PURCHASE OF OR AMALGAMATION WITH A BUSINESS	19
The starting point—Surveying the position—Matters to be investigated—Avoidance of overlapping—Compar- ison of revenue accounts over years—Use of balance sheets—Some vital points—Should liabilities be taken over?—Special points of importance to ingoing partner	
CHAPTER VI	
THE FINANCIAL POSITION OF A CONCERN . . .	34
Solvency and stability—Scrutinizing the records—Use of costing systems—Assessment of compensation for loss of business profits—Profits not always a fair basis—Com- pensation for partial acquirement	

CHAPTER VII

REORGANIZATION	41
Causes of inquiries—Method and extent of investigation	
—Reporting the result of the inquiry	

CHAPTER VIII

SALE OF A BUSINESS	47
General considerations—Making adjustments—Certificate as to profits	

CHAPTER IX

SUSPECTED IRREGULARITIES	56
Special observations—Misappropriations and defalcations—Embezzlement of cash—General procedure to discover extent of defalcations	

CHAPTER X

INVESTIGATIONS OF FRAUD CASES—GENERALLY .	63
Discovering fraud and trapping defrauders—Types of fraud—By whom frauds are committed—Frauds by employees—Frauds by owners—Frauds by directors—Some actual frauds reviewed	

CHAPTER XI

INVESTIGATION OF AFFAIRS OF A COMPANY WHERE FRAUD IS ALLEGED AND IN CASES OF LIQUIDATION	79
Under winding-up order—Knowledge of Companies Acts—Examination of documents—Transactions with allied companies—Examination of persons—Public examination—The accounts—The report	

CHAPTER XII

COMPULSORY ACQUISITION OF LAND AND BUILDINGS	94
Powers of public bodies—Urban district councils—Municipal corporations—County councils—Rural district councils—Parish councils—Basis of assessment—Rules for assessment of compensation—Special points to be observed—Examination of claims—Leasehold interest—Stock—Fittings and fixtures—Removal expenses—Loss of business and profits—Principal matters affecting chief financial officers	

CONTENTS

ix

PAGE

CHAPTER XIII

EXECUTION OF CONTRACTS ON A FLUCTUATING PRICE BASIS OR COST PLUS PROFIT . . .	102
Inconstancy of prices—Nature of the agreements— Types of contracts—Contract price—Starting the inves- tigations—Wages—Materials—Value of this type of investigation	

CHAPTER XIV

INVESTIGATIONS ON BEHALF OF PERSONS PRO- POSING TO INVEST	115
General points for consideration—By taking ordinary shares—By taking preferential shares—By taking de- bentures in a company—By making a loan—Charging of assets	

CHAPTER XV

INVESTIGATIONS ON BEHALF OF A SHAREHOLDERS' COMMITTEE	126
Scope of the investigation	

CHAPTER XVI

INVESTIGATION OF TRUST ACCOUNTS	128
Statutory provisions—Line of action—Apportionments —Where the business is carried on—Liability of investi- gators	

CHAPTER XVII

INVESTIGATIONS INTO AFFAIRS OF DEBTOR WHERE CREDITOR DESIRES TO MAKE DECISION CON- CERNING DEBTS	138
Bankruptcy or liquidation—Inspectorship deed	

CHAPTER XVIII

INVESTIGATION ON BEHALF OF PERSON PROPOSING TO SUPPLY GOODS ON TERMS OF EXTENDED CREDIT	141
---	-----

CHAPTER XIX

INVESTIGATIONS INTO ACCOUNTS FOR INCOME TAX PURPOSES	143
---	-----

CHAPTER XX

REPORTS ON INVESTIGATIONS 145

Style in the report—Essentials in the report—Preservation of notes

CHAPTER XXI

A MATTER OF ETHICS 148

Dishonest cash collectors—A question of rent—Outwitting cunning—Making opportunities for bribes

CHAPTER XXII

INTERNAL INVESTIGATION DEPARTMENT 151

Internal audit and investigation department combined—Special utility to local authorities

CHAPTER XXIII

MISCELLANEOUS POINTS 154

Outside information—Bound books and loose-leaf ones—Prevalence of wrongful handling of monies—Accurate accounts may need adjusting—Dangers of ultra-prudent policies—Miscellaneous profits—Goodwill—Miscellaneous points—Special points not to be overlooked

INDEX 159

INVESTIGATIONS

ACCOUNTANCY AND FINANCIAL

CHAPTER I

MEANING, SCOPE, AND OBJECTS OF INVESTIGATIONS

No one who understands the work involved in an investigation or who appreciates its importance will hesitate to endorse the statement that of all the tasks which an accountant is called upon to perform, none imposes upon him a greater burden of responsibility than does a diligently carried out investigation into the affairs of another ; as, no matter what the object of the inquiry may be, very important issues depend on the investigator's report.

Meaning of the Term.

The term "investigation" may in a general way be defined as "a special audit." But it is something more than an audit, and yet it is not absolutely necessary that an audit, in the sense in which a professional accountant and auditor examines books, need even be part of an investigation. An investigation is a careful search and inquiry, not only into accounting records, but into all circumstances and matters which may directly or indirectly have an important bearing upon the object for which the inquiry is being made. Theoretically, there is no difference in method between an audit and an investigation, for both aim at a complete

disclosure of facts. But the objects of an audit are not the same as those of an investigation. Whereas an audit is of a critical nature, consisting of an examination of accounts and records already prepared, an investigation usually involves the building-up of accountancy records as well as audit work.

Another difference is that while an auditor usually starts his work without any definite technical instructions and with no object in view other than the verification (or otherwise) of the records of a particular period (usually a year), an investigator commences with a definite object in view.

An audit in many cases really covers little more than a verification of the arithmetical accuracy of the books, though it is claimed that its object is to detect technical errors, to detect fraud, and to detect errors of principle. But a rigorous investigation should achieve all these objects, together with a disclosure of other important information which has been specially sought for.

Objects of an Investigation.

There is practically no limit to the circumstances in which an investigation may be called for. Any transaction, event, or circumstance can be the subject of an investigation. Investigations are undertaken chiefly—

- (1) Upon the acquisition of an undertaking;
- (2) On behalf of the purchasers upon the purchase of or amalgamation with a business;
- (3) On behalf of the vendors of a business;
- (4) For the purpose of obtaining special information about the financial position of a concern, such as—
 - (a) the basis of a claim for compensation for loss of profits, etc.;
 - (b) the acquisition of shares or debentures in a company;

(c) the lending of money on the security of freehold or leasehold property or against other security or personal guarantee;

(d) the decision of a creditor concerning the action to be taken against a debtor whose liabilities are not being satisfactorily discharged;

(e) the solvency of a firm with whom the person or body is a creditor or about to become one;

(f) the financial stability of a firm about to enter into a contract with the investigating party;

(5) With a view to a possible reorganization on more economical or efficient lines of an existing concern or department;

(6) With a view to the discovery of suspected fraud, and an inquiry and report on the conditions that enabled the fraud to be perpetrated, and the extent of the defalcations and recommendations calculated to prevent a recurrence of fraud;

(7) On compulsory acquisition of land and of freehold and leasehold buildings;

(8) When necessity arises for an efficient scrutiny of the books and accounting records of a firm of contractors doing work for which the charge is one on a basis fluctuating according to market prices; or where the sum payable is on a time-and-material basis plus profit;

(9) On behalf of a shareholders' committee;

(10) Under the provisions of the Public Trustee Act.

Extent of an Investigation.

In every case of investigation it is necessary to obtain clear and concise instructions from one's client or principal, preferably in writing. Where the scope of the instructions is not sufficiently wide, and thus during the course of the investigation it is found that one is hampered by the limits set, it may be essential to report

4 INVESTIGATIONS: ACCOUNTANCY AND FINANCIAL

on the facts of the inquiry down to that point, and to procure further authority before proceeding. Then, if the matter is not to be developed, a final report can be prepared and presented, indicating, for example, that all work has been completed within the scope of the client's requirements.

In cases where *carte blanche* is given the extent of an investigation is, of course, governed by the circumstances leading up to it and by the object which it is desired shall be attained. Knowing these, only the accountant himself can determine the exact or probable extent of his inquiry, and even he may not be able to fix this until he is nearing the end. He will have a good idea from the outset, but little things have a habit of coming into prominence and altering the course. Or it may be that the accounting records are incomplete, in which case a vast amount of diligent inquiry behind the scenes is necessary if the goal is to be satisfactorily reached.

A certificate that is so qualified as to amount, in effect, to little more than a carefully safeguarded expression of what might be or might not be is almost useless. It is not of much value if an accountant, after a brief examination of records available, merely states that the position "appears" to be so-and-so. He must be more certain and reassuring and, honestly to be so, he must exercise his ingenuity and his wits and "think" the thing properly out. His line of action bears little resemblance to the course he would take were he merely the professional auditor. Rather does it generally start where the auditor finishes, though in some cases a complete audit may be necessary, as a preliminary. This leads to a point of importance, viz. to what extent may properly audited figures be taken as correct by the investigating accountant? By this is meant, can figures

verified by a *bona fide* professional auditor acting for the other side be accepted by the investigator? Having regard to the fact that the firm's auditor is a man with a professional status to maintain, and is one of unquestionable integrity, the reply would appear to be in the affirmative. But in some cases, and here the investigator's discretion is required, the answer must be "no." And this rejection of a professional brother's figures does not stigmatize him, but even pays him a compliment.

Many matters, including legal and accounting questions, are open to two interpretations, the one being opposed to the other, and this being so, it is only reasonable to assume that counsel or accountant will act in the interests of the person who has briefed him.

The extent to which such figures may be acted upon is a matter for the investigator to determine in his own discretion. He it is whose name will be attached to the report.

A point not to be overlooked is whether or not the records submitted to the investigator are real or spurious.

Limits of an Investigation.

A regular audit professes to discover the true position of affairs in a general sense. An investigation attempts to disclose the facts so far as a particular object is in view.

A matter for consideration is that concerning the acceptance or rejection of records without checking them. The importance of this point is not to be overlooked, because valuable time may be saved or wasted through foresight or lack of it. One simple illustration will suffice to make this clear. If a firm contracts to execute work at a figure, subject to adjustment on the rise

6 INVESTIGATIONS: ACCOUNTANCY AND FINANCIAL

or fall of the market price, it is quite certain that all invoices and records will be submitted to the investigator without demand *if the price has risen*, and so he need not worry about those accounts not produced *so far as advances are concerned*. The contractor will have looked after himself, and even if he had not claimed all to which he was entitled, it would not be to the detriment of the firm or corporation employing the investigating accountant. But unfortunately there is no assurance that a contractor will so cheerfully produce those figures that appear to keep his profits down.

CHAPTER II

QUALIFICATIONS OF AN INVESTIGATING ACCOUNTANT

MANY and varied are the qualifications and abilities an accountant needs if he is to be a successful investigator. A large number of these are not strictly of an accountancy nature except in so far as it may be contended that members of that profession are the better for being "all-round" individuals.

Attributes of an Investigating Accountant.

The attributes of a competent and successful investigator include the power to see things as they really are; the faculty of stating facts and opinions lucidly, and a habit of fearless honesty of purpose. He must not be easily misled or capable of persuasion of taking a course which may mislead those who rely upon his skill and reputation.

It is perhaps superfluous to state that a deep understanding of accounting should be coupled with as perfect a knowledge of the principles of auditing as it is possible to have, and that a vast practical experience of the application of them in many different types of business is essential.

But no less important are numerous other personal attributes; in fact, these latter are, it may be thought, absolutely necessary qualifications.

The qualifications in question are an all-round knowledge of men and their ways; tact; patience; self-possession; perception; quick thinking; humour; literary ability; character; and personality.

Though there is no need to enlarge unduly on this phase of the subject in the present volume, a brief

indication of the main ideas in the author's mind in regard to them may not be out of place, especially to the younger accountant who has not yet had the opportunity to learn by experience.

Knowledge of Men and Their Ways.

To a very large extent the success and skill of an investigating accountant depends on his common sense, his general knowledge of commercial customs, and his all-round knowledge of men.

Quite recently Judge Sir Alfred Tobin is reported to have said (when addressing a jury composed of women, whom he had seen taking notes of the remarks made by witnesses, etc.) that they would be better able to judge the truthfulness of the witnesses by watching their faces and manners than by taking notes of their statements.

Everyone knows individuals whose word they would not willingly take without insisting on the fullest possible proof, and of others whose character is judged to be of the opposite kind—not because of proof but because they have acquired in the course of a business career, involving the meeting of thousands of persons, an ability to judge men by their manner and faces more than by their words.

A defrauder may be so adept that he hides his character under a mask. An investigator who can penetrate the mask is needed.

Tact.

It is an accepted fact that a man's will cannot be broken by breaking his head. Try to appeal to the mind through the reason and the will is untouched. One should aim at the heart if one would succeed. When that is touched it is easier to convince him.

It has been said that talent is something, but tact

is everything. Though it is not proposed here to support the statement in its entirety it certainly contains a large element of truth. Tact is the art of adjusting the relationship between oneself and others. It thus follows that lack of ability to make the adjustment with satisfaction to oneself and without injustice to the others is a serious handicap.

Tact is necessary in relationships within a business and in relationship with the outside world, and particularly with clients and customers. Tact can be positive or negative.

It should govern speech. It is as necessary to know when to be silent as when to speak. The business man with diplomatic instinct knows these times. He can keep a secret, and he is no more likely to disclose information when cunningly "pumped" than he is to blurt it out spontaneously. On the other hand, his ears are always ready to listen to anything spoken to him that is not empty gossip. Thus tact is shown not merely in saying the right thing at the right time to the right person, but is also often exhibited equally in leaving things unsaid or in referring to them only lightly or evasively. The question of tact in conversation is a very important one.

Tact exists in actions, too. One may call it diplomacy if one prefers.

Patience.

This is another quality with which some are blest while others lack it. Of all work which falls to the lot of an accountant that which cannot safely be rushed is audit and investigation work. Things are better done deliberately, and, quite apart from the fact that if hurried, points may be missed, things which may be achieved with patience may be entirely lost if adequate

time be not spent on their proper consideration and treatment. While not of so much importance as a qualification as character reading or tact, the patient man is, perhaps, better equipped than the hasty.

Self-possession.

This is a trait well placed in the ownership of an investigator. To "lose one's head" would be an almost fatal calamity for him. He must be able to keep mentally calm in all circumstances. No matter how agitated he may feel within, he must not let the slightest trace of it be apparent to anyone but himself. Especially is this so in an investigation where there is any suspicion of fraud. One false or careless move or hint may ruin the chances of success in the case. No hasty remarks should be made, no matter how apparently justified. As in most battles of wits, he who can keep his head longest has a decided advantage over an adversary who cannot. The man who "loses his temper" or perhaps, to be correct, "finds it," can generally be beaten by a cool opponent within a few minutes of the fight starting. The easiest man to beat, the defrauder most readily discovered, is the hot-headed individual. With some trepidity, but certainty, the writer urges that if it will help to trap a wrongdoer, a process of instigating him to rashness in his manner and speech by literally inciting him to "lose his head," is justifiable on the part of an investigating accountant.

Perception.

Without a keen perception a man is not much use as an investigator. As a "ticker" of course he may have his uses, but not as an investigator. This quality is needed to a remarkable degree. And lest any earnest though inexperienced student mistake the term for one

indicating excellent optical powers, it had better be stated that such idea of a definition would in these circumstances be wholly wrong. It means the faculty of receiving knowledge of external things by the medium of *any* of the senses.

Quick Thinking.

Allied with perception is quick and clear thinking. It often happens that a matter has to be dealt with at once; on the spur of the moment. And much may depend on the judgment exercised in that brief period. If a person cannot in an emergency think both clearly and quickly in a way that he would choose if he had plenty of time in which to ponder over the matter, his personal equipment does not stand at par value.

Humour.

Humour restores the balance lost by the toil of bitterness of life. A person who is easily disheartened is not the man most likely to overcome difficulties, while nothing is a better incentive to the maintenance of good spirits than a sense of humour that will make a jest of something in circumstances which to others would cause a sinking heart. It is a great mistake to take everything *too* seriously; such is one way to the lunatic asylum. It is, of course, true that much of the ability to see the funny side of grave things is a native gift, but some part depends on cultivation. A splendid motto is "Be cheerful." The value of the power to adjust mental conditions is very great. It often means the difference between radiant hope and black despair.

Literary Ability.

Though of less importance to an investigating accountant than technical knowledge and the possession of

the special qualities already outlined, a good literary ability is a valuable personal asset. It is necessary for an investigator to frame a report on the investigation he has made. How much more interesting and pleasant to read will it be if couched in well-chosen words and phrases? The importance of attaining this ability is rapidly increasing. To have the requisite knowledge in one's mind is not enough; one must be able readily to impart it in pleasant language. The study of accountancy (even by wide reading of textbooks and technical papers) instead of helping the reader to acquire literary ability rather stilt his style. It is not agreeable to read a report by one who, though an expert so far as the subject-matter is concerned, has a severely limited vocabulary, and who uses what he has very poorly. In presenting one's facts the aim should be to attract and retain the readers' or hearers' attention. This is accomplished by making the facts interesting and by expressing them pleasingly.

In trying to acquire literary skill one should read good literature, and a considerable variety of authors should be chosen. This is better than copying one style, no matter how good that one may be. By versatility in reading an original style may be acquired combining the fine features of each writer without the monotony of any of them.

Character.

It may seem out of place, or at least redundant, to suggest the necessity of integrity in an accountant and investigator. But there have been cases, fortunately few perhaps, where integrity has not been the strongest point in the accountant's equipment. Of all methods of earning a livelihood there are few, if any, in which the loss of a good reputation or moral character means

more than in that of accountancy. Not only would an unfortunate be struck off the membership rolls, but in consequence of the very confidential nature of the work of the professional accountant, nobody would in future entrust his affairs to him.

Personality.

If an investigating accountant, or internal auditor (or indeed anyone else) is the happy possessor of a good share of all the foregoing attributes, he is not likely to be without a "personality." Simply defined, the term means distinction of person.

The next suggestion will probably seem strange to many. It is that one should read detective fiction. But an investigator expects strange things to happen in his work. In his investigations he must always strive to get at the truth. There is an English maxim that truth is stranger than fiction. Much of the sensational or detective literature produced by good writers is mainly fact, the only fictional part of it being the names used to avoid libel actions, and sundry "fillings" and smoothings of rough corners, etc. However, such tales give one a very good insight into the ways of defrauders and others. In the best of the books of this type one finds the characters particularly true to life. The present writer once heard an eminent physician and surgeon say that of a fairly big series of books of detective fiction involving a great deal of medical, surgical, and scientific knowledge, there was not one mistake. Whether other volumes contain errors or not, the fact remains that they sharpen one's wits, and provide an excellent training of thought in the right direction. They do not necessarily solve the investigator's problems for him, but they teach him how to track, to trace, and to find what he is seeking.

CHAPTER III

STARTING POINTS OF INVESTIGATIONS

THE starting point naturally differs according to the type of investigation under review, but considered generally, it is commonly found in representations made by a certain person or persons. The merit of such initial statements varies enormously, as they range from carefully-prepared statements from circumstances and systems well founded and organized, to casual jottings unskilfully prepared with an imperfect knowledge of the facts and even to hearsay or conjecture.

Discovering the Reason.

An investigator should always on starting try to discover the reason for the suggested or arranged desires. Valuable information about a firm can often be obtained from sources which by law are open to the public, such as the Register of Companies and the Register of Business Names, prospectuses, and filed balance sheets, rate books, etc. If necessary, credit agencies can be approached who will supply information regarding the commercial position of the firm inquired about, its credit, its reputation, etc. While a debtor is not always anxious to give all the information desired by the investigator, it is often quite easy to get help from insurance companies, banks, solicitors, accountants, etc., by a *bona fide* investigator.

Ascertaining the Character of Persons Concerned.

Before commencing an investigation it is desirable so far as possible to make inquiries as to the position

and character of the persons concerned with the business, e.g. the promoters or proprietors. A man is apt to be known by the company he keeps, and this applies to business as well as outside it. Where a person prominently connected with a concern to be investigated is one known to bear a bad reputation, it is more than probable that the firm with which he is concerned is not likely to be a good investment for a man of better character. And it may be mentioned in parenthesis that an accountant (except, perhaps, as investigator) will not as a rule do himself much good by being mixed up in undertakings of this kind.

CHAPTER IV

THE ACQUISITION OF AN UNDERTAKING

AN investigation necessary upon the acquisition by a local authority or other public body of an undertaking such as a gasworks, a transport, or other trading concern, privately owned, will be considered by way of illustrating the first type of investigation named in the list given on pages 2 and 3.

Quite apart from a verification of the assets, which is not necessarily the accountant's duty, the ascertainment that the book value is approximately correct, and that the balance sheet is in order, the investigator will undoubtedly proceed to verify the revenue or profit and loss account.

Profit not Understated.

It may be taken for granted that the vendors have not under-estimated the income, the strength of the financial position and the profitable nature of the business. Consequently, it is not necessary to inquire with the same exhaustiveness as would be used in the case of an audit into the completeness with which every source of income has been duly accounted for. Nor is it so necessary to consider the validity of the items of expenditure charged in the accounts, nor to check such payments with the vouchers. But, on the other hand, he must certainly satisfy himself that no item of expenditure has been omitted or understated, or that the income has not been overstated. Such deliberate mis-statements would not intentionally be made by an honest vendor. But all vendors are not in this

category, or at least are not very high in it. And there is always the danger that what the seller really believes to be true and correct has been fraudulently manipulated by one of his employees for the purpose of concealing defalcations, or even that he has an innocently wrong conception of the real state of affairs.

It is quite possible that the vendors have not thought it inconsistent with their consciences to omit from the debit side of the revenue account considerable items of overhead or management charges, e.g. partners' salaries, directors' fees, etc., on the ground that the persons were not employees, nor to overlook the fact that had such individuals not been there, paid managers etc., would have been necessary.

Methods of Falsification.

The two principal ways in which books may be falsified in order to conceal fraud are—

- (1) by falsifying the balance sheet by overstating assets and understating liabilities; and
- (2) by falsifying the revenue account by understating income and overstating expenditure.

Falsified Balance Sheets.

In both of these cases where the balance sheet has been tampered with, the purchaser is not necessarily prejudiced, as the assets taken over are generally vouched by an independent valuer, and the investigating accountant is not likely to assume responsibility for the accuracy of the book debts without a careful inquiry into their correctness. It is by a falsification of the balance sheet items that defalcations, if considerable, are more likely to be concealed, rather than by a falsification of the revenue account. A material understatement of profits would be extremely dangerous, as

18 INVESTIGATIONS: ACCOUNTANCY AND FINANCIAL

attention would thereby be drawn to the existence of a leakage.

A falsified balance sheet ought not to escape the attention of an investigating accountant.

Falsified Revenue Accounts.

Under the second method of fraud in accounts, viz. the production of a falsified revenue account to conceal defalcations, the purchaser would actually gain by the defalcations, for the profits would be less than the figure shown by the books, and consequently the purchase price of the goodwill would be determined on too low a basis.

CHAPTER V

PURCHASE OF OR AMALGAMATION WITH A BUSINESS

WHEN commencing an investigation of this kind it is an important matter to inquire carefully as to the reasons which cause the vendor to part with the business. The investigator should not confine his questions on this point to the vendor, but should address diplomatic questions to other persons connected with the business with whom he may come in contact. The value of the business is naturally not affected where it is an actual fact that the vendor is retiring on account of age, or that he has amassed a fortune, or that his health necessitated retirement. But a vendor is apt to mention, in a casual off-hand manner, a reason such as one of these without expressly stating that such is the actual case, but with a view to misleading the purchaser into making a false conclusion.

The investigator should therefore be careful to inquire into these points, so that he can afford the purchaser the fullest information on this important matter.

The Starting Point.

The starting point in a case of this kind is generally the representation or claim made by the vendor or proprietor of the value of the business, in which will be stated the alleged value of assets, the profit-earning capacity, etc., of the business. The representation may be founded on accounts properly audited, coupled with professional valuations, or it may be merely an estimate based on casual jottings of notes prepared without skill

and with an imperfect knowledge of facts. And, alas, in some cases it is made with a complete disregard of truth and of facts which become quite obvious to the accountant when the investigation is being carried out. One can only determine the lines on which the investigation is to be performed after one has inspected the representation made and the information available for the purposes of verification. It may even be found that it is not verification that is needed, but a complete re-statement (or statement) of facts in intelligible form.

Surveying the Position.

As has already been stated, an investigation ought not to involve a complete audit. A general survey of the position should be made, including inquiries as to the conduct of the business, particularly the accounting side of it, and then a general plan of campaign may be drawn up, having for its main object a general test of records. The general test may indicate the necessity for a close examination of detailed records in certain respects. Information obtained may with advantage be compared with knowledge of similar businesses, if such is available. If not, independent inquiry may be resorted to with a view to forming an opinion as to the truthfulness of the information furnished. As the work proceeds a gradual feeling of confidence or distrust is usually acquired, and this will have an important effect on the investigation and on the report.

Matters to be Investigated.

Certain matters cannot be overlooked with real safety by reason of the variations in methods of treatment, each good in its way perhaps, but in respect of which a variation made designedly or otherwise might cause a big disparity from the true figure when

consistency is practised. Such matters include the following—

Uniformity in stocktaking.

Treatment of works in progress.

Bases of valuation of stock, e.g. is any overhead expense included in the figure?

The foregoing are given to indicate the possibilities which might arise if there is not uniformity of treatment in one period as compared with another. Profits may, by adopting such expedients, be apparently enhanced or reduced, and similarly may losses be manipulated.

Many other matters require investigation. For example, income tax paid should be eliminated from the profit shown, because the actual amount paid bears no relation to the particular year in which it is assessed. Another item subject to similar treatment is interest on borrowed moneys.

An average figure of profit (even though strictly correct) over a number of years is not necessarily a true indication of the present position and prospects of a business. The tendency may be a steady or even severe downward one, and yet by reason of earlier years' profits, or an exceptional intermediate period, the average may be quite good. Nor even can a statement more nearly approaching the ideal and showing steadily improving results be taken without careful scrutiny, because such a position is that which it is the natural desire of a vendor to show. Careful attention must be paid to verify the genuineness of the figures shown.

Avoidance of Overlapping.

There should be no overlapping of items relative to different periods if a true earning capacity is to be reflected by the accounts. Items requiring allocation should be apportioned with utmost care.

The question of depreciation is a difficult one for the investigator, partly because it calls for technical knowledge, and also by reason of the fact that its provision is apt to be of an irregular character. For instance, in times of adversity no depreciation may have been charged in the accounts, while in reverse conditions large sums may have been set aside. Thus the actual wear and tear that has taken place (and which is the figure that ought strictly to be charged in the accounts) may bear no relation to the provision made in the accounts.

Briefly stated, the accounts have to be adjusted, if necessary, to eliminate every item not being part of the real trading expenses and income, and to bring in all items in this category which ought to be there.

Comparison of Revenue Accounts Over a Series of Years.

A comparison of corresponding figures over a term of years is desirable. Commencing with these, an investigator should compare them with each other, and see whether or not they indicate a steady or consistent condition of affairs; whether the turnover fluctuates materially, and whether increasing, at a standstill, or diminishing; whether the percentage of gross profit is fairly constant and such as is usually earned in undertakings of the kind in question, and whether the percentages of expenses and net profit to gross turnover are reasonably steady. A marked reduction of expenses during the last year or years must be viewed with the greatest suspicion, for such reduction, if excessive and not *bona fide*, may have a very serious effect upon the future prospects of the undertaking.

As far as is reasonably practicable, the investigator should examine the *bona fides* of all sales, especially

those recorded during the last few months. The prices of at least a portion should be compared with current rates, and any appreciable increase in the amount of sales, or in the number of new accounts opened, should be regarded with suspicion. All entries "on approval" must be disallowed, and where sales are post-dated it seems essential to make sure that they have actually gone out of stock. The entries for the next few weeks immediately after the closing of the books should be carefully scrutinized, and if they show an exceptionally large number of returns, or a remarkably small amount of sales, he must draw his own conclusions and satisfy his curiosity as to the *bona fides* of the entries. In dealing with consignments, one should remember that the goods may have been invoiced out at selling prices, while the unsold balance can only be allowed for in the accounts at cost price (plus expenses) at most. Another point which must not be lost sight of is the question of travellers' commission; care should be taken to charge commission upon all sales that are included in the accounts. Due allowance must also be made for all outstanding discounts; and empties which are returnable, but not yet returned, cannot safely be taken credit for at the full price charged.

With regard to the purchases the problem is similar to sales, but somewhat simpler, because the investigator can usually get access to the creditor's statements. It is, however, necessary to be on one's guard against the omission of post-dated invoices when the goods have actually gone into stock.

Where reliable stock accounts and cost accounts have been kept, there exists a very valuable corroboration of the contents of the trading account; but where these cannot be obtained, one has to do one's best with the material available. It is extremely important that the

various stocktakings should be conducted upon similar lines—i.e. they should be based upon the same scale of prices, due allowance being made for the depreciation of articles no longer in fashion, or in small quantities, and for “out” sizes. If the various stock lists have been prepared upon different scales of prices, they must be recast upon a uniform method, as any such difference may very materially alter the profits shown by the accounts. The valuation of the stock-in-trade made by the valuer should be compared with the vendor’s stock-list, and if there is any material difference between the two, the investigator should not fail to examine the effect of such difference upon the accounts. Thus, supposing one arrives at the conclusion that, throughout the past three years the stock has been consistently over-valued, say 20 per cent, and supposing the stock is £10,000 heavier at the current time than it was three years before, it is obvious that during those three years the net profits have been over-stated £2,000, or (say) £700 a year. This makes a material difference when one comes to pay a number of years’ purchase price for a goodwill.

When the stock consists of such articles as cotton, iron, lead, grain, etc., which have a definite but unstable market value, the question of the legitimacy of profits arising from such alterations in value as may have occurred is a consideration of no slight importance.

It is obviously inadvisable to take profit upon the rise in value of unsold stock, although revenue must be debited with the contingent loss arising from any fall. No profit should be included as part of the trading or manufacturing profits that has arisen out of a “gamble” pure and simple, but gambling losses cannot safely be ignored. Where any considerable portion of the profits has arisen from favourable fluctuations of value—as

opposed to true commercial profits—it is very desirable that the two sources of profit be distinguished in the report. All purely exceptional profits (e.g. the fact that an important exhibition had been held in a particular industry, or an altogether exceptional contract executed) should always be specially noted in the report.

Use of Balance Sheets.

For the purpose of scrutinizing the position relating to bad debts, repairs, renewals, and depreciation, reference to the balance sheets as well as to the profit and loss accounts is necessary. In dealing with bad debts, the fact that one is concerned with several years' accounts helps to a certain extent. An average may be struck and compared with one's experience of the average usually obtaining with similar classes of undertakings. The book debts of the first year, at least, are almost certain to be either collected or else written off before the end of the third year, and thus the percentage of the first year's actual bad debts upon its sales may be compared with the percentage written off each year. Such a comparison is only tentative, but it is useful so far as it goes. One should carefully examine the last schedule of book debts. It is probable that the investigator will know a large proportion of the names set down, and if he finds that the schedule contains names that other clients look upon as bad or doubtful, he should bear the fact in mind. In all cases a sufficient provision for bad and doubtful debts should be debited to revenue account.

With regard to the question of depreciation, the position is perhaps a little more difficult. Generally speaking, if the values set out in the balance sheet exceed the amount of the valuer's estimate, such difference should be added to the amount of the depreciation

debited to revenue during the period under review. This method is not, however, infallible, as the valuation at the commencement of the period may have been too high—in which case the effect would be of charging an undue amount against the profits of the current period; or it may have been too low—in which case there will not have been charged enough. Normal average rates of depreciation may be used to verify the results obtained from the accounts, and previous experience, combined with sound judgment, will be of further assistance in the matter. Repairs should in all cases be charged up to revenue; but actual renewals need not be, provided due allowance has been made for depreciation.

Where part of the assets to be taken over consists of shares in other companies, care must be taken to see that these are included in the accounts at their proper value. Where shares (perhaps unquoted shares) have been received in payment of book debts, especial attention is necessary, as the trading results are directly affected. In no circumstances should profit and loss account be credited with more than the normal value of the work done until the shares have been actually sold, and if the profits realized on such shares make up any appreciable portion of the total profits, the fact should be specially named.

Where patents form part of a proposed purchase, and where such patents have not been submitted to a specialist for valuation, the investigator should see—so far as possible—that the inventions purchased are actually protected.

Depreciation.

Where it would be difficult, if not impossible, to determine the probable depreciation, it is safer to

certify a figure of profit before including depreciation, and to make a qualifying note to that effect.

Cash Discounts.

These may not have been received in the past in consequence of shortage of working capital, and if it is supposed that benefit will arise under this heading in the future, the matter should be fully explained in the report, pointing out that profits have been included that have not been made in the past.

Scope of Certificate.

An investigating accountant cannot include in his certificate any profits anticipated in consequence of more skilful management in the future. His certificate should be based on facts, and although certain adjustments may be desirable (and even necessary) so that a correct impression of these facts may be gathered, in view of the altered conditions which it is expected will obtain under management, in no circumstances should a certificate as to profits degenerate into anything which could possibly be described as an estimate or a guess of what may, in certain circumstances, be expected to happen in the future.

Having collected sufficient data to enable one to form a general impression of the business under review, one may now study the general mode upon which the business has been conducted, and may form one's own opinion of the personnel of the management. The accountant will have ascertained the amount of capital required to conduct the business upon its present lines, and will have formed an opinion as to the scope it offers for an increased capital (if such a thing be contemplated). He will also have ascertained how far the continued success of the undertaking depends upon: (a) successful competition; (b) the continuance of a

monopoly; and (c) the caprice of public demand; and have formed an opinion concerning their continuance. He will now be able to gauge the probable success of the venture. How far, if at all, should an investigator's opinion upon these points be reflected in his report is a matter for careful consideration.

If it be conceded that the object of the accountant's investigation is to supply the place of an independent examination by each proposed shareholder, it must be admitted that these opinions are entitled to some expression. But any expression of personal opinions should be cautious and not dogmatical, and should be very clearly separated, and it should never degenerate into either an estimate or a prophecy.

Some Questions to Determine in Connection with an Investigation for the Purpose of Purchasing or Amalgamating with a Business.

Some important points in this category are—

1. Will the business be affected by the retirement of the vendor? E.g. he may during the last few months have materially *damaged* its reputation or have improved it, or he may contemplate setting-up a competitive business.

2. Are all the items in the profit and loss account *bona fide* revenue receipts and expenditure?

3. Do the actual charges in the accounts for income tax bear a proper relation to the alleged profits as declared by the vendor?

4. If the vendor is remaining in business, is there any restraint as to the area in which he may operate, and does he retain the right to solicit old customers?

5. If liabilities are not taken over by the purchaser, will the vendor actually liquidate them? If not, the business reputation might suffer.

6. The liability to the Inland Revenue is on the basis of the previous year's profit, and if trade is declining there is the liability for assessment on the last year's figure to be paid in the next year.

Should Liabilities be Taken Over when a Business is Purchased ?

In the acquisition of a business it is important to ascertain whether or not it is proposed that the purchaser should take over the liabilities. There is a good deal to be said either way on the subject. It may be argued that it is preferable for the vendor to pay off the liabilities out of the purchase price, and thus free the purchaser from any liability in respect thereto. It is highly desirable that that should be done. But the purchaser will have no control over the disposition by the vendor of the purchase price. The purchase of the business is, as a rule, completed at the offices of the vendor's solicitors, when the property of the business and the documents of title relating thereto are handed over to the purchaser and the vendor receives cash for the purchase price. Thus the purchaser has no opportunity in such a case to see that the vendor does apply the purchase price in payment of the liabilities so far as may be necessary.

Assuming that the vendor does not apply the purchase price in payment of the liabilities, then whilst the purchaser does not of course become legally responsible for those liabilities, it must be remembered that their non-payment will very materially affect the goodwill of the business in future, since trade creditors are not generally prepared to recognize in a favourable manner the change of ownership when they have not been paid in respect of merchandise which they have previously supplied to the proprietors. On the other

hand, one cannot advise the purchaser to take over the liabilities without knowing a good deal about them, and it is to be recommended that a schedule should be drawn up after correspondence has taken place between the investigating accountant and all the creditors so as to enable it to be as accurate as possible. Arrangements may then be made either whereby the purchaser undertakes to pay those liabilities—effecting, of course, a suitable adjustment on the purchase consideration—or whereby the full purchase price is not paid to the vendor, but so much thereof is retained by the solicitor or accountant acting for the vendor as will enable him to discharge those liabilities.

Special Points of Importance to Ingoing Partner.

Where the investigation is on behalf of a person proposing to take a partnership in a business, some special features call for inquiry. For instance, where a person buys a whole business he generally understands the technical nature of it, whereas it may happen that a person acquiring a partnership has no knowledge of the special nature of the business of which he is seeking to become a part owner.

The special features to be investigated are—

1. The technical knowledge necessary for the proper and satisfactory conduct of the business, so that the investigator may advise his client in such a way that the latter is aware of any difficulties that may present themselves to the proprietors of the business, and of any facts which might act as a deterrent to his acquiring a share of a business with which he would not really like to be associated. The matter is of vital importance, for it must be remembered that where one partner has all technical knowledge, a partner not possessing that

knowledge is at a great disadvantage as a proprietor of the business. The newcomer is, to a very large extent, in the hands of the man who possesses the necessary knowledge. Any such individual may not be a desirable partner, and if inquiries indicate adversely he is still more undesirable if the control of the business would be entirely in his hands.

2. The business may be of a type that the investigator's client would not care to be associated with if he knew its real character. The points here indicated may be strictly legal, but still not such as everybody cares to be connected with. It is a question of ethics, but it is advisable that any such point be brought to the notice of the client for whom the investigation is being made, not with the idea of prejudicing him, but with a view to placing the fullest possible information before him so that he may decide this point for himself.

3. The situation of the business is another point to bear in mind.

4. Another matter of very considerable importance concerns the reason why an additional partner is needed. If it is to take up the share of an outgoing partner, it is necessary to ascertain the value of that outgoing partner to the business. The success of the firm may depend very considerably on the services of the outgoing partner, and his value may not be compensated for by the technical or other knowledge of the incoming partner or the remaining partners. The value of the share of goodwill must be considered from the point of view of the fact that the services of the retiring partner will not be available. Where the incoming partner does not possess the necessary technical knowledge it is perfectly clear that it is his money which is required, either for the purpose of paying out a retiring partner (the new partner taking up his share)

or to provide additional capital for the business. If the latter, the investigation must be directed to ascertaining the reason why such capital is wanted. While it may be due to the fact that the expansion of business necessitates the introduction of further capital it may, on the contrary, be due to the fact that the existing partners have been improvident in their conduct of the business, and that they have drawn out more money than the business could reasonably be expected to provide.

5. The investigating accountant should be afforded access to information concerning all material facts, no matter from whom such have to be obtained, and any reticence on the part of the existing partners should be regarded as a warning and an indication that extreme care and inquiry are necessary. Cases have been known where accountants have investigated books, but certain information has been withheld from them on the ground that the principals of the business considered it private, but agreeing to disclose the facts to the client personally. Such a course should not be agreed to by the accountant making the investigation, and he should advise his client in such a case that unless the facts required are disclosed to the person entrusted with the investigation, negotiations should be broken off on the ground that, however satisfactory it might appear to the client, it does not follow that the account given of the particular points would be satisfactory to a person skilled in investigating such matters.

6. The probable profit which could reasonably be expected to accrue to the new partner, that he may judge whether or not it provides a satisfactory return for his labour and his capital.

7. The proposed value to be attached to the ingoing partner's share of the goodwill.

8. The question as to whether or not the amount of capital required to be introduced by the new partner is reasonable.

9. If it is considered that the values placed upon the partnership assets are excessive, it is obvious that the existing partners' capitals must be correspondingly inflated, and this would affect the ingoing partner prejudicially so far as both the proportion of profits taken by the present proprietors and the value of the new partner's share in the event of a dissolution are concerned.

10. The investigator's report to the prospective partner should deal with all vital matters and be sufficiently full and lucid to enable the client to determine whether or not he is satisfied with the proposed terms of admission into the proprietorship of the business.

11. The financial clauses in the proposed partnership agreement.

CHAPTER VI

THE FINANCIAL POSITION OF A CONCERN

INVESTIGATIONS conducted with the object of obtaining special information about a business, e.g. verifying a claim for compensation, proceed on lines not much different from those just given, attention being paid almost exclusively to the profit and loss account.

Solvency and Stability.

Where the object is to ascertain the solvency or stability of a firm, a careful audit is a necessary preliminary to an investigation of all alleged assets and liabilities.

Though such a verification is the object of an ordinary audit, generally in such cases the certificate of a responsible official of the firm as to the existence and value of buildings, plant, stock, etc., which, if not inconsistent with book records as shown by a comparison of the present time with previous periods, is accepted by the auditor. But where it is desired to ascertain in the interests of the person or firm for whom the investigator is acting as exact a state of affairs as it is humanly possible to determine, some deeper inquiry into the solvency of the firm's debtors, the real value of the assets, the state of the firm's trade (whether it is declining or increasing), and even the probabilities of its future prosperity will be necessary.

The extent of this investigation will depend on the importance of the matters at stake, and in extreme cases may include a complete valuation of all assets by an

independent valuer, and a circularization of all debtors asking for a confirmation of their liability.

Scrutinizing the Records.

Then the investigating accountant will compare the revenue accounts of the last few years to see whether a steady or consistent state of affairs is indicated, whether the turnover is diminishing, stationary, or increasing, whether the percentage of gross profit is fairly constant and reasonable, and whether the percentages of expenses and net profit to gross turnover are satisfactorily steady. Any adverse conditions must be inquired into, as they may indicate a serious effect upon the future prospects of the firm.

So far as is reasonably practicable, the *bona fides* of all sales, especially the most recent ones, must be examined, any remarkable increases being scrutinized. All sales must be traced to have gone out of stock. The entries in the books for the next succeeding period should be carefully inspected, and if an unusually large number of returns is found, or if the sales are exceptionally small, suspicion as to the genuineness of the previous entries will be roused.

A somewhat similar line of action should be applied to the purchases and expenses, care being taken to see that invoices have been passed through the books for all goods taken into stock, or that a necessary adjustment has been made in respect of outstanding bills. This matter is more important and of far greater magnitude than at first may be imagined. It is quite reasonable to assume that in a case where the expenditure on materials is, say, £5,000 a month, the value of materials taken into stock but not yet invoiced is £4,000. Great as the desire may be to get hold of the money for goods supplied, it is surprising how dilatory

many firms are in rendering accounts, especially where the solvency of their debtor and likelihood of payment are beyond doubt.

Use of Costing System.

Where a reliable system of costs and stores accounting is in operation, a very valuable corroboration of the financial books is available. One need hardly mention that it cannot be counted prudent to take as legitimate profits, gains arising from increases in the market value of unstable commodities.

Assessment of Compensation for Loss of Business Profits where Properties are Acquired for Public Purposes.

The conditions under which compensation may be granted, and the basis of its assessment are governed by the Land Clauses Acts, 1845-1919.

The basis of the compensation payable by the public body is the value of the properties to the owner. Not merely the present or immediate value, but potential values, too, must be included. In other words, the compensation should be based on the imaginary price which the properties would fetch if offered for sale before the local authority or other body had obtained its powers of compulsory acquisition. An alternative, and sometimes more equitable, basis of compensation is that of reinstatement, i.e. the provision of equivalent accommodation on a suitable site.

It will be seen that an imaginary price might be regarded as the value of goodwill because the purchaser might acquire it, but such a contention is in most cases wrong. It is true that the Acts already referred to provide for consideration of goodwill, but only to the extent of injury to it. When a public body acquires

properties compulsorily it does not purchase the goodwill too. It does not want the goodwill. Such remains the property of the vendor. And this very important fact should be borne in mind when checking or assessing a claim for compensation. The loss to be paid by the local authority is only that estimated to be suffered by diminution in value as a consequence of compulsory ejection and probable removal to another site.

Many vendors claim big sums for loss of goodwill quite in addition, of course, to those for other more tangible properties disposed of, and it generally happens that the figures have to be cut down very considerably.

It will already be appreciated from what has been stated that as the compensated person retains the goodwill, any claim for the full value of it, based as a rule on a number of years' purchase price of the profits, must be rejected at once. In considering the amount of injury all circumstances have to be taken into account. The nature of the business, whether wholesale or retail; the proximity and the relative value of the new site; any special value the old place has by reason of its situation, such as being a corner shop seen equally well from two or more thoroughfares; or its contiguity to institutions the patrons of which patronize the shop solely by reason of convenience; all these have to be considered to enable an equitable figure to be ascertained.

It is impossible in a short work on investigations to deal fully with all contingencies. Indeed, many important points are appreciated only when a particular case comes up for consideration and the circumstances peculiar to that case are known. But it is believed that these observations will enable a person charged with the duty of assessing or investigating a claim for compensation to proceed on right lines. In the hope that

they may be of general guidance, the following outstanding features are given—

In the case of wholesale businesses, those doing a trade over a wide area, both personal and mail-order work, the actual loss in goodwill might be almost negligible, provided reasonably convenient premises are to be obtained, and the compensation for goodwill need not much exceed the mere cost of removal. Contrasted with such a case is the retail shop whose customers are almost entirely local and particularly so if no suitable premises are obtainable close by. In these circumstances the injury to the goodwill is practically one hundred per cent of its value.

Profits Not Always a Fair Basis.

That past profits do not always form a fair basis is evidenced by the fact that the business may have been actually run at a loss, but compensation is morally due in respect of goodwill arising out of reasonable expectations in consequence of an improving locality, etc. When taking the average profits over a period it is very important to note whether the figures are fairly steady one year with another, or whether there is an upward or a downward tendency in profits. It is quite obvious that in equity a great difference should be made in the amount of compensation payable on an average profit when there has been a very marked falling-off in trade as compared with a greatly improving or growing trade. It is impossible to give a definite basis as to determination of the amount of compensation, but in the latter case the amount should be much greater than in the former. Assuming that certified trading and profit and loss accounts have been properly tested and agreed as being accurate by the investigator, such figures even then will need adjusting before they can give a fair

basis for compensation. Some such matters are as follows—

1. Interest on working capital should be deducted from profits because, without any exertion on the part of the trader, the capital in the business if invested would produce a certain income; therefore there can be no loss so far as the figure so ascertained is concerned.

2. The rent figure included in the account may need adjusting either up or down. The actual rent paid may be that arising out of a lease, and may be less or more than a fair figure for all such premises at the time.

3. Another question that should be considered is that as to whether any deduction from profits should be made in respect of management expenses where the claimant or his wife have devoted their services to the business without charging a salary thereto, on the ground that had a paid manager been employed the proprietor's profit would have been less by the amount of the salary paid. On the other hand, the discontinuance of the business may cause a loss to the claimant in that he or his wife may not be able to find so remunerative an outlet for their labours. Though there may be differences of opinion on this point, there does appear to be a good reason why he should be compensated for the loss.

4. Abnormal years' profits or losses should be omitted from averages.

It may be useful in cases where an investigation has failed (probably through absence of information which may be genuine, lack of documentary evidence, or the wilful withholding or destroying of records in the hope that the largeness—and unreasonableness—of a claim may not be disproved), to ask for production of the claimant's income tax assessment. Though it is not here inferred that an investigating accountant has a

right to demand the production of such a document, any reticence on the claimant's part suggests that his claim is not good. If it is shown that a claimant has paid income tax on a basis which has included as profits the figure he has put forward in his claim, it is reasonably correct to assume that such profits have been made. The necessity of his having to prove to the Revenue authorities that he has not made such profit, and to the local authority that he has made them, places him in a dilemma which it is contended should force him to disclose the true position.

Compensation for Partial Acquirement (i.e. Severance).

The property acquired may be simply a garden, and in such a case compensation may be payable not merely for the loss of the garden, but also for the depreciation in value of the house or business in consequence of the loss of its amenities.

Compensation in respect of land is payable to the owner in possession, and if held on lease to both freeholder and lessee, or if a yearly tenancy, to freeholder and tenant. The amount payable to a freeholder is the present value of the reversion at the end of the lease, that to the lessee is the present value of the difference between the actual rent paid and the improved annual rent that the property is worth.

Compensation payable in respect of land regarded as an unhealthy area within the meaning of the Housing Acts is (in accordance with Section 46 (1) of the Housing and Town Planning Act, 1919) to be based on the value of the land as a site cleared of buildings, and having regard to the purpose for which it is wanted, and thus no compensation accrues in respect of the buildings thereon or for loss of trade.

CHAPTER VII

REORGANIZATION

THIS type of investigation is one adopted with a view to reorganization on more economical or efficient lines of an existing concern or department. The title is self-explanatory.

A consideration of the causes leading up to an investigation of this kind and the method and extent of the inquiry are very important.

Causes of Inquiries of This Nature.

Investigations of this kind generally arise—

(a) when the finances of a business, a local authority, or other public body, get into a bad state;

(b) when there is obvious or apparent lack of efficiency and organization on the part of the officials, the board of management, or the committee; or

(c) following the death or retirement of a partner, manager, or chief financial officer, with the object of having the position fully reviewed, reported upon, and recommendations made (if necessary).

Methods and Extent of the Investigation.

The extent of an inquiry of this nature would certainly be ascertained so far as practicable before commencing, as it is imperative that the investigating accountant know what he is expected to report on. The exact extent of the inquiry and the specific lines of his action can only be determined as he becomes

acquainted with the task in hand. Written instructions from the persons authorizing the investigation should be obtained in order not only to guide the accountant, but to authenticate his actions in case opposition of any description be encountered.

Assuming for purposes of illustration that the case of a public body be taken, statistical information relating to the local authority, including rateable value, rates in the £ levied, loan debt, population, etc., would be obtained. Reliable information as to the character of the town (e.g. whether residential, industrial, wealthy, or poor), methods of rate collection, and definite information of the authority, its operations, and its inhabitants are also very helpful.

The investigation would involve a full inquiry into the following matters—

1. The method of accounting.
2. The method of preparing estimates for rates.
3. The method of supervising and controlling expenditure and income.
4. The organization of the administrative work.
5. The co-ordination (or lack of it) between spending departments.
6. The existence (or otherwise) of proper centralized financial control.
7. Banking arrangements.
8. Income tax assessments.
9. The presence (or absence) of efficiency in the form of modern up-to-date methods, including mechanical devices.
10. The system of collection of rates and revenues.
11. The system of internal and other audit (if any) in force.
12. Claims for Government grants in aid (whether fully claimed and obtained).

13. The methods of raising loans and of dealing with sinking funds and redemption funds (whether economical or not).

14. The adequacy of provision for redemption of debt.

15. The sufficiency, excess, or under-provision of insurances.

16. The valuation of assets for balance-sheet purposes.

Reporting the Result of the Inquiry.

The result of the investigation would be reported upon and recommendations made (if necessary) for the better management of the affairs.

Recommendations.

The nature of the suggested changes must necessarily depend on the conditions already obtaining and the local circumstances. The recommendations arising out of an imperfect system in respect of many of the matters set out above (items 1 to 16) are obvious. A few observations on some of them may, however, be helpful.

Where the system of accounting is purely on cash lines without periodical conversion, the method of preparing estimates for rates will probably be on the same basis, in which case the true financial position may not be readily apparent. It may even be obscured by design. The full charge may not be levied in the rates.

There may be no periodical comparison of actual spendings and income with the estimated figures.

Revenue expenditure may be charged to capital account or capital expenditure may be charged to rate account without any value being placed on the assets so acquired.

Bank interest and commission may not be properly checked, and poor terms with the bank may be in operation.

Full advantage of all income tax set-offs, allowances, exemptions, repayments, etc., may not have been taken.

Much attention may be required with regard to the organization of the work, including the grading of the staff according to particular duties for which they are best fitted. Any duplication of work or overlapping of duties should be avoided. Adequate internal check arrangements should be recommended. The introduction of modern mechanical devices, card systems, etc., may ensure expeditious results with less labour and expense.

Many other matters may need attention. They will arise in the course of investigation, and will be reported upon and recommendations made on sound financial lines.

As a final word it should be remembered that real economy does not consist of avoiding expenditure, but in spending advantageously.

Warnings.

Mention has been made of the possibility of recommending the use of mechanical devices. Undoubtedly this is, as a general rule, a very desirable part of a reorganization, and one that may, in suitable circumstances, lead to considerable economies.

It should, however, be borne in mind that careful consideration of this aspect of the subject is necessary. In the first place, the advantages of the apparatus installed are not always really what the managers or salesmen of the device claim them to be, nor are the economies alleged to be due to the use of the apparatus wholly attributable to it.

These points should, it is contended, be correctly

stated by the investigator in his report, or his recommendation may be quite justly criticized and found to be inaccurate, in which case much that he has put forward may be severely discounted. This will not enhance his reputation.

Perhaps one or two illustrations of the author's meaning in regard to this matter may be helpful in making his advice clear.

An out-of-date, cumbersome system of pen-and-ink accounting may be in operation where an investigator is called in to report on the position and to offer recommendations. From the antiquated system he may suggest a complete turnover to the most modern machinery and claim the saving to be wholly attributable to the machines. This would obviously be incorrect. The only credit due to the mechanical devices is the saving over the best non-mechanical system. An out-of-date organization could be improved tremendously without machinery.

Another fallacy into which one could fall, if one took the machine vendors' statements at one hundred per cent value, arises because much of the estimated saving is theoretical only, and from a practical point of view dwindles down very considerably when put to the test.

For instance, if it is recommended that the preparation of many departmental or branch statements be transferred to head office, there to be done with mechanical aid, the saving at the branches may be stated with theoretical accuracy at 400 hours per week, the equivalent of ten men's whole time, and thus a cash saving of, say, £30-£40 per week—a very appreciable item, especially if stated as £2,000 per annum against a few hundreds for the use of the machine. Now, the 400 hours to be saved may be the result of shifting small

portions of clerical work from fifty to a hundred out-places to head office, an average reduction in weekly work per depot or branch of four to eight hours. Such a small saving at each place does not permit of the dismissal of *one* person, let alone *ten*, and so, instead of a saving as claimed, there may be an actual loss consisting of use of machinery, wages of operators, and rent of room or floor space to house them.

Other instances could be given, but it is thought enough has been stated to indicate the warning note, which the writer desires to issue, when dealing with cases involving alleged savings by centralization.

CHAPTER VIII

SALE OF A BUSINESS

THIS chapter deals with investigations on behalf of vendors of businesses.

General Considerations.

In conducting an investigation on behalf of vendors into the accounts and records of a business proposed to be transferred, and with a view to giving a certificate of profits for insertion in the purchasing company's prospectus, the accountant should not overlook the fact that he is not only responsible to his employing clients for the work he performs, but that he also bears responsibility towards the public, as on the faith of his certificate as an expert, the public will be asked to subscribe for shares in the company. It is necessary that he should ascertain, so far as possible, the *bona fides* of all parties interested in the matter, as in the event of the new company being unsuccessful, and legal proceedings being taken, he will be involved in the matter. For this reason alone it is desirable that he retain a complete record of all material information obtained, and of the manner in which he has arrived at the figures he certifies, so that, if called upon to do so, he may be in a position to substantiate his certificate.

The period to be investigated is, as a rule, determined by the parties instructing the investigator, although his opinion may be asked on the point. Usually a period of from three to seven years is taken, the object being to arrive at what might be regarded as the normal trading profits during that period. The accountant should confine himself strictly to the ascertainment of

facts, and should not indulge in calculations or problematical estimates of future operations.

It is unnecessary to state that where the books of the business have been properly kept and regularly audited by reputable accountants, the work of the investigator is materially facilitated, and one is reasonably entitled to assume that the books are arithmetically and ordinarily correct. The auditor's reports on previous accounts should be called for and inspected. Where the accounts have not previously been properly made up and audited, a more detailed task, involving accountancy and auditing, lies before the investigator.

A trading and profit and loss account for each year of the period should be drawn up on a uniform basis in order to afford easy comparison. For the purpose the columnar principle, with a column for each year's money figures and another for percentage in relation to turnover, is admirable. A balance sheet should be prepared on similar lines.

In examining the trading accounts it should be noticed whether the ratio of gross profit is constant or variable. And if the latter, the cause of the variation must be ascertained, as if it is not due to fluctuation in the cost of materials or increase or decrease in wages or other manufacturing expenses, or variations in selling price, it is probably due to errors, or manipulations in the values of stocks, etc. The values of goods on hand at the end of each period should be compared with one another to ascertain whether the total stock held tends to rise or fall in relation to the turnover. If there is a considerable increase in the stock, without a corresponding increase in trade, the cause may be inflation of values. Comparisons of the turnover of each period should be made for the purpose of ascertaining progression, and the cause of any abnormal variations.

The various classes of expenditure should be compared, and any fluctuations in their ratio to turnover inquired into. A careful and systematic comparison of the accounts will indicate special expenditure incurred in any year in excess of the normal.

Comparison of the balance sheets affords valuable information as to amounts taken as the value of the various classes of fixed assets, debtors, reserves, cash balances, and items of expenditure carried forward, trade creditors, and variations in the capital employed in the business.

From the information so obtained the investigator will be in a position to decide as to the extent of his examination.

This done, the commencing balance sheet should be checked, the impersonal ledger examined (all totals from subsidiary books being checked thereto), and cash postings tested. The balances on nominal accounts should be checked each year to the profit and loss accounts.

Detailed vouching is not usually necessary, especially where an audit has been previously performed, as the investigator is not so much concerned with the manner in which the payments have been made, or whether they can be satisfactorily vouched, as with the normal profits of the period.

It is perhaps as well that all capital expenditure be vouched, as if this be done all remaining expenditure must be of a revenue nature.

The assets accounts should, therefore, be checked in detail, and all capital expenditure vouched, care being taken to see that it is properly chargeable to capital account and not merely expenditure in the nature of repairs and renewals, which should have been charged to revenue account.

All stock sheets should be examined and tested, and it should be observed that they have been duly certified, and that the basis on which prices have been taken is uniform throughout the period. If stocks have been taken above cost, or insufficient depreciation has been allowed for spoiled or obsolete stock, adjustments should be made accordingly.

Care must be taken to see that no consignments inwards (goods received on sale or return and thus belonging to third parties) are included in the stock.

The basis of valuation should be examined and approved, and uniformity over the periods represented by the accounts should be maintained.

It should be verified that "sales" do not include goods sent out on sale or return, and thus in the hands of agents, or on consignment. If transactions of this nature have not been properly recorded, adjustments should be made, in order to eliminate from each year's accounts the profits taken credit for in respect of such items.

Outstanding liabilities at the end of each year should be verified as far as possible, special attention being paid to any items that disclose undue variation. The method upon which bad debts have been provided for should be ascertained, and the debtors' balances at the close of the period checked in detail, with a view to ascertaining that sufficient provision has been made.

The accounts relating to the last year of the period under review may advantageously be examined in greater detail, especially if the profit has increased, as it is possible that manipulations may have been carried out with a view to making the accounts show an increase in the profits of the last year. Manipulations of this kind may be done by inflating the closing stock

figure; by including fictitious sales; by omitting purchases or other outstanding liabilities; by understating the provision for bad debts or depreciation; by "starving" the business by excessively reducing expenses; or by paying business liabilities out of private moneys. A comparison of the figures in the manner already indicated should enable the investigator to detect any variations that might be due to one or other of these causes.

The investigator should compare the percentages of expenditure to turnover, not merely one year with another, but with the ascertained normal percentages of other businesses with which he is familiar. This will enable the investigator to judge whether the expenditure is reasonable in the present circumstances and may lead to discovery of a consistent practice of paying business liabilities out of private moneys with a view to a subsequent flotation.

Where the accounts contain items of charge covering more than one financial year, proper apportionments should be made. If sales during the last few months of the closing period show a considerable increase, with a corresponding increase in the outstanding debtors, the sales should be tested with the order books, and goods issued book, in order to ascertain whether they are *bona fide*; and, if necessary, the accounts of the succeeding period should be examined to see that no excessive returns or allowances have been put through to cancel the sales entered in the previous period. To discover whether purchases have been omitted, the goods received books covering the close of the period should be tested with the bought journal, and the reasons for any marked decrease in expenditure should be ascertained.

The closing balance sheet should be checked in detail.

Making Adjustments.

Having investigated the accounts as far as is considered necessary, and being of opinion that they are correct, the investigator will, without doubt, have to make a considerable number of adjustments before the profits can be arrived at for the purpose of inclusion in the certificate. The object of the certificate, of course, is to afford information as to the earning capacity of the business in the past, from which can be drawn conclusions as to its probable earning capacity in the future. For this reason, although the certificate should deal with past facts, it is necessary to adjust the profits of the business to the conditions that will obtain in the case of the new ownership.

The following adjustments will usually be found necessary—

Add to the profits—

(a) Interest on partners' capital and current accounts, partners' salaries and income tax. (These are not charges on, but appropriations of, profit.)

(b) Interest on loans and overdrafts, if any, except where any of the loans will be taken over by the purchasers; otherwise it will be assumed that they will be provided with sufficient working capital and that such charges will not need to be incurred.

(c) Rent, if the purchasers intend to acquire the trade premises hitherto rented by the business.

(d) Discount on purchases, which, owing to lack of working capital, the vendor has not been able to avail himself of, and where it is expected that the purchasers will be in a position to do so.

(e) Losses not arising in the ordinary course of a well-organized business, such as those arising by reason of (1) insufficient insurance (although in such cases the full insurance premiums should be charged).

(2) defalcations, (3) costs and damages incurred by actions at law, and (4) other exceptional items.

(f) Capital loss, such as loss on sale of fixed assets, or investments.

(g) Expenditure of a capital nature, such as have been charged against revenue account.

(h) Excessive reserves for bad debts or other contingencies.

Deduct the following items from the profits—

(a) Income from assets not being taken over by the purchasers.

(b) Rent, if no charge has been made for this item in the profit and loss accounts, and the purchasers are not going to acquire the premises.

(c) Profits of an exceptional kind not arising out of the normal business.

(d) Capital profits, such as profits on investments or on sale of fixed assets.

It is generally preferable that the profits be stated after making adequate provision for depreciation where this can be done. The purchasers may not, however, base their provision for depreciation on values identical with those in the books of the vendor, and thus, unless the rates of depreciation are based upon the new values, the inclusion of charges for depreciation that may have been sufficient in the past may be misleading. In cases where difficulty would be experienced in arriving at a proper rate of depreciation, it is perhaps better to add back the actual charges for depreciation to the profits, and give a certificate clearly indicating that depreciation has *not* been provided for in the figures given. It is also preferable to certify the profits without the inclusion of directors' fees, indicating, of course, the position in the certificate.

Where the purchaser is a limited company formed to

take over a business which has been built largely as a result of an extensive advertising campaign, it is quite possible that the normal advertising necessary to maintain the turnover so created cannot be estimated. If no advertising is charged in arriving at the certified profits, it is essential that the certificate should not only clearly indicate that this is the case, but it should state the actual cost of the advertising which has been utilized in creating the business, and has been ignored in ascertaining the certified profits.

Certificate as to Profits.

A certificate as to profits should indicate the precise periods covered by the investigation, and be worded in clear and unambiguous phraseology. Where only ordinary adjustments have been made it may be sufficient to state that all necessary adjustments in the opinion of the investigating accountant have been made, but where special items of importance are involved these should be specifically set out. It is desirable that the profits for each year be shown separately, especially where they are on the decline, as an average certificate given in such circumstances might be misleading. As the status of the professional accountant has a very great value in the eyes of the public, it is essential that no member of the profession should give his information in a manner prejudicial to the public, merely for the purpose of obliging the vendor or company promoter. Every professional accountant should give his opinion in the fairest manner possible, so that no member of the public may be misled by the form of the information which he gives.

The certificate should deal with facts, and estimates or opinions should not be given, as it might be supposed that such estimates or opinions were actual facts

elicited from the books, and thus a wrong impression would be obtained. It is undesirable that the accountant giving the certificate should indicate that any particular set of charges will be covered by future profits, or that he should (whatever his knowledge may be of the particular class of business) express any opinion as to the possibilities of the actual business to which the certificate relates.

The certificate should be such that an ordinary intelligent person, whether a business man or not, can therefrom assess for himself the possibilities of the business. It should be framed with the utmost care and caution.

The following is an example of a simple certificate such as might be given by a reputable firm of accountants—

We have examined the books of John Smith for the three years ending 30th June, 1930, and find that after making the proper adjustments, but before charging depreciation on buildings, plant, machinery, and tools, the profits were as follows—

			£	s.	d.
1928 .	.	.	16,871	8	4
1929 .	.	.	19,363	11	9
1930 .	.	.	18,257	16	1

Signed

Incorporated Accountants.

MANCHESTER,
9th August, 1930.

CHAPTER IX

SUSPECTED IRREGULARITIES

THE type of investigation dealt with in this chapter is one made with a view to discovering suspected fraud, together with an inquiry and report on the conditions that enabled the fraud to be perpetrated, the extent of the defalcations and recommendations calculated to prevent a recurrence of the malpractices. To an appreciable extent much that has already been written earlier in this book is of equal application to inquiries of the kind now under review.

Special Observations.

Some special observations on this type of investigation may, however, be helpful.

It must be remembered that the mere routine of auditing will probably disclose only clerical errors and simple frauds. Seldom will it reveal frauds that have been skilfully planned and concealed. In order to discover these, it is necessary to go behind the actual books of account, and to examine original records and make deep and intelligent inquiries.

In cases of clever frauds, the actual entries in the books and records will, as a rule, be found in apparently perfect order. The defalcations are often concealed by the omission of records from the books of account, by spurious records and documents, or by fictitious entries.

Investigations will be influenced by the system of accounting, organization, and internal check methods in force. It is only after considering the whole system that the investigator will be able to tell where the organization is weak, and where possible loopholes for

fraud exist. In these directions special precautions will be taken, whereas in cases where the internal check is good, haphazard tests may suffice.

Many an extensive fraud has originated in a small, insignificant item.

Experience and character of the investigator will prevent him from being easily put off by plausible explanations at the initial or other stage of a fraud. If the defrauding party is clever, the defalcation will be skilfully concealed, and he will be ever ready with plausible explanations for any inquiries raised.

No less important than that the investigator should be a person of character is the necessity that he should be able to judge character in others. Coupled with this might well be included his power to judge evidence. Often does one make inquiries, and often is one dissatisfied with the explanations obtained, even though there are no grounds on which to base the dissatisfaction, nor perhaps even are there any real grounds for suspicion. Nevertheless, on inquiries and scrutinies being pursued relentlessly, defalcations or malpractices may be revealed. Cases have been known where an exhaustive investigation has disclosed no actual discrepancy, or probably only a few doubtful points in respect of which apparently good explanations were forthcoming, and yet the investigator felt—one might say by instinct—that something was wrong. And in the end, by absolute “bluff” on the investigator’s part a confession has been wrung from the delinquent. This instinct may have been caused by the general attitude of the person concerned and the untrue ring of the explanations.

Misappropriations and Defalcations.

Cases of misappropriation or defalcation that have occurred in the local government service (and elsewhere)

within recent years have been rendered possible by the fact that the whole accounting and financial system of a department or service have been in the entire charge of one man (usually an old and trusted servant), assisted by one or two juniors and perhaps a new clerk. In such circumstances there is no internal check, and it is wellnigh impossible to prevent fraud if the man is dishonest.

Misappropriations of goods are even more difficult to discover than are defalcations of cash (though of no less importance), if proper stores accounts are not kept. How many well-intentioned individuals would think nothing at taking small articles from stores for some domestic purpose, yet who would regard a colleague who instead stole a shilling from the cash as a person not to be associated with? Stores cost money and are the equivalent thereto, and generally need as much consideration and protection.

Embezzlement of Cash.

Defalcations involving misappropriations of cash or stock vary so much according to the nature of the goods, and the business and the methods of discovery are so well known to all trained accountants, that a detailed survey of the whole ground is not necessary in this treatise. The observations are thus limited to outstanding features and indications of the general lines of procedure.

Where the fraud is one of misappropriation of cash it is desirable that full inquiries be made as to the authority exercised by the defaulter, and of the nature of his duties, in order to glean some indication of the opportunities he may have had at his disposal. Probably he has been in general control of the books and has been able to do practically what he liked, in which case

the investigator should make a complete investigation from a date arranged with the owners of the business, paying particular attention to the following points.

General Procedure to Discover Extent of Defalcations.

The cash book should be cast and vouched in detail, and certificates obtained of the opening and closing bank balances. The pass-book should be checked completely with the cash book, particular attention being paid to the dates when moneys received were banked and the ascertainment that each day's receipts have been included.

Where moneys received from debtors have been misappropriated, it is not uncommon to find that, in order to prevent the debtor's account from appearing as outstanding, moneys received from subsequent debtors are placed to the credit of the debtor whose remittance was originally misappropriated, this process (known as "teeming and lading") being continued indefinitely. In these cases it is often necessary for the dishonest cashier to divide certain cheques in order to obtain the exact amounts necessary for his purpose, and one method of discovering whether or not this has been done is to obtain from the bank the original paying-in slips and to compare them with the counterfoils or carbon copies of the paying-in book. The slip presented to the bank contains a correct record of the amount of each cheque, whereas the "copy" will show any improper division that may have taken place. This inspection also serves as a check upon the wrongful manipulation of discounts by the same methods. All discounts of any appreciable amount appearing in the cash book should be tested, in order to find out whether or not they are in order.

Copy receipts should be checked with the cash book, and where rough cash books have been kept, these should be compared with the fair copy cash book.

It should be verified that the proceeds of all bills receivable have been duly received, or that the bills are actually in hand.

With regard to cash payments, especial care should be taken, in examining the vouchers, to discover any irregular ones. It is advisable also that returned cheques and endorsements thereon be examined. Where vouchers are missing, duplicates should be obtained. All amounts charged to the drawings accounts of partners should be vouched by the partners as being correct.

A very probable source of petty fraud is the petty cash book, and so this should be vouched and cast.

Special attention should be paid to salaries and wages, and the investigator should ascertain that there are no "dummy" employees, and that the amounts purporting to have been paid have been received by them and are correct.

A good method of verifying the balances on debtors' accounts where it is suspected that amounts have been misappropriated, is to send out circulars to the debtors, stating the amount shown in the books as outstanding and asking for communication to be made to the investigator direct if the figures are not correct. As some proprietors do not like this proceeding, their permission must be obtained before proceeding. If they object it should be pointed out that if circularization is not carried out it will be impossible for the investigator to be sure that he has traced all the misappropriations from this source until they are declared automatically as and when statements are sent out.

Where the defaulter has had access to all the books, it is generally necessary for the whole of the postings to be checked, and for the books to be cast, and a trial balance prepared. In checking the sales ledgers, attention should be paid to all allowances and bad debts written off, as entries of this nature may have been made for the purpose of concealing misappropriations of cash. Similar treatment should be applied to returns, and where necessary the receipt of the actual goods returned should be traced. In some cases it may be found there has been an omission to record sales in the sales day book, so that when remittances were received they could be appropriated without having to falsify the books further. In order to ascertain whether this has been done, the order book should be compared with the sales day books, to see that all orders executed have been entered up, and, if necessary, reference should be made to the goods issued book. Where cash sales have been made these should be vouched in detail with whatever evidence is available, although in most cases it is a difficult matter to ascertain if irregularities have occurred.

Invoices should be vouched with the purchases journal, in order to ascertain that none have been passed through twice, payment in respect of the original invoice being made to the creditor, but payment for the duplicate being misappropriated by the defaulter. Duplicates should be obtained of missing invoices, and creditors' statements should be compared with the balances as shown by the creditors' ledger.

In businesses where there are many cash sales it is necessary to examine the system by which they are supposed to be handled. The recognized method is to arrange that the sales assistants do not handle cash, but make out the sales note in triplicate, the copy

retained by the cashier acting as a check on the salesman, and that kept by the latter as a check on the cashier. Where the system is lax it is a difficult (if not impossible) matter to trace defalcations. If the receipts from cash transactions have declined either as a whole or so far as a particular assistant is concerned, full inquiry should be made into the matter. Additional indication of misappropriations may be obtained by comparisons of cost of materials bought, with sales (less gross profit) and stock on hand at the time of the inquiry.

CHAPTER X

INVESTIGATIONS OF FRAUD CASES—GENERALLY

AN accountant called upon to investigate known or suspected fraud cases is perhaps the better able to perform his task if possessed of a well-developed instinct.

In the well-known *Kingston Cotton Mills* case Mr. Justice Lopes said that an auditor is a watchdog and not a bloodhound.

The circumstances in which the auditors of the accounts of the Kingston Cotton Mills rightly approached the records were in the capacity as ordinary auditors and not as investigators of fraud. Had they been appointed to discover known or suspected fraud it is quite probable that even the judge would have held that the person undertaking the task should be more of a bloodhound than a watchdog. However, from practical experience the present writer feels that a strong detective instinct is a very valuable quality in an investigator of fraud cases.

Discovering Fraud and Trapping Defrauders.

It is generally easier to detect fraud than to gather sufficient evidence to support the wrongdoer's adequate punishment. Many fraudulent practices would be prevented if the accounting arrangements were properly organized.

Beware of the "old and trusted servant." Many of the extensive frauds have been perpetrated by or through the existence of such an individual. The honest servant, whether old or young, does not resent proper organization, internal or external audit, or investigation. He has nothing to hide. On the other

hand, the issue of a clean bill by the investigator, even if not clothed in commendation and words of appreciation, pronounce his state to those who matter and afford him a certain amount of satisfaction.

Individuals in this category do not make a showy pretence of a desire for the inspection of their books; such practice is a sign that all may not be as it ought to be, especially if the opportunity for fraud is of the kind that is difficult to discover from books alone.

When conducting an investigation one should devote a proportion of the time available to a scrutiny of the face and general demeanour of the person (or persons) responsible for the records. It is quite possible that more may be learnt from that source than from the figures in the books. This will be facilitated by unobtrusively arranging for him (or them) to be placed in a good light. The judge can afford to be in the shadow.

Many misappropriations and incorrect accounts arise by the omission of vital points rather than erroneous statements and inaccurate figures. If discovered it is in some cases difficult to charge anyone with anything stronger than negligence or incompetence, whereas a spurious document or entry is incriminating evidence. Omission of cash sales and debits for "credit" sales are frequently met with.

Materials can be misappropriated as well as money. Probably a hundred such cases arise to one of cash, but discoveries are probably in inverse ratio.

Types of Fraud.

Frauds may for the present purpose be divided firstly into two main classes—

1. Petty frauds, and
2. Large frauds.

The perpetrator of merely small thefts, such as

postage or insurance stamps, and of trifling sums of money, is too mean a case to merit special consideration. The prevention of such despicable deeds may be stopped by a tightening-up of the accountancy arrangements, and while such task would come within the scope of an investigator's duty if instructed to inquire into, report on, and make recommendations for an improvement in the accounting organization, an investigator would not ordinarily be called in to track and trace a petty fraud only.

A person who can embezzle £170,000 (as actually happened in a bank fraud) and get away before he is detected, is one who possesses ability which, if developed in the right direction, ought to carry him far up the ladder of fame and fortune. More recently, there has been the Hatry case, greater in magnitude, but not perhaps so ingenious in its construction.

A great many other frauds could be named, but a few brief references will suffice for present needs. There have, within recent times, been some comparatively big embezzlements in the municipal world. One of £84,000 and another of £46,000, both in comparatively small local authorities, and some others each reaching five figures, are cases not to be treated too lightly. There have been a great many frauds which have not been discovered through the actual medium of ordinary audit. The business of an auditor is to see that the accounts, as presented to the proprietors of the business, represent the true state of affairs. Consequently, the majority of frauds which have occurred from time to time have come to light probably as the result of an accident rather than in consequence of any particular activity on the part of an auditor, but that, of course, does not necessarily reflect in any way upon the auditor. The fact that some person is coming in to verify the

accounts from time to time, to check securities, to count cash, to cross-examine one about the entries which have been made in accounts, and so forth, is in itself the finest moral check that one can have.

By Whom Frauds are Committed.

The persons by whom frauds are committed in businesses are of three classes—

1. The employee.
2. The owner of a business.
3. The director.

The majority of cases come in the first class. Next come those by the owner of a business, and lastly (perhaps, mainly, it is thought, because of the fewer opportunities, than that the individuals are more honest) by directors.

Frauds by Employees.

The employee may steal with a view to enriching himself, or probably with a view to enabling him to meet the claims of his creditors upon him, because it is a fact that nine times out of ten, when a man gambles and loses, it is his employer who pays his losses, and it is a rule of the London Stock Exchange that no broker can open a speculative account with an employee without the sanction of the employer. The reason is obvious. Some employees pilfer their employers' goods and money from motives which they think are quite good and justifiable, such as where they (rightly or wrongly) consider they are underpaid or are badly treated, or that they themselves have been the means of directing large profits into their employers' pockets and have not been suitably rewarded for their prowess.

Another form of fraud may arise from a desire to bolster up a business with a view to showing that things

are going better than they really are, and thus faking of the books take place. This type of fraud may be carried out in two distinct ways. The actual embezzlement of cash or the theft of goods and the covering thereof by false entries; or making the position seem better than it really is with the idea of maintaining one's job at a higher salary. The first means misappropriation or embezzlement, and the falsification of the books; the second entails only falsification.

Frauds by Owners.

The types of fraud committed by owners or principals of a business are entirely different in their motive. Some arise from a motive to show a better position than is actually the case, particularly when they happen to be responsible for the management of the business. Fraud may be carried out by the proprietor or proprietors of a business in order to present a much better state of affairs than really exists, with a view to obtaining a larger purchase price for the business, and, of course, a bigger amount for goodwill. This type of fraud is much more common than one would imagine, but it is sometimes difficult to tell where misrepresentation ends and fraud begins.

Other cases of fraud by owners are committed with a view to defrauding the Revenue authorities. They understate their profits in an endeavour to escape some or all of the income tax and surtax for which they are really liable.

Some special observations on investigations of this type of case are given in Chapter XVI.

Frauds by Directors.

Frauds by directors are in a slightly different category, because a director's opportunities of actually

embezzling the company's cash or of misappropriating its goods are very remote, unless he happens to be a managing director who is left in control of the company. Directors acting in such a manner may be actuated by one of two motives, viz. either the object of enabling the company to pay a dividend when profits have not been good, or that of paying those dividends to maintain the value of shares in the market. In such cases it is not usually the object of the directors personally to enrich themselves, although as holders of shares they would get some benefit out of any dividends that may be paid. It may be due to a desire to avoid unnecessary and unpleasant explanations to shareholders in general.

In the case of Farrow's Bank, for example, there was a desire on the part of directors to make things appear very satisfactory; to show a profit when no real trading profit had been made; to declare dividends in order to maintain the confidence of depositors in the company; but the result was a fraudulent balance sheet and a compulsory retirement on the part of two of the directors. Nobody suggested that either of those directors actually made very much out of that particular fraud, and it must be distinguished from the frauds which have as their object the enrichment of the perpetrators.

As has already been stated, the procedure at an investigation depends on circumstances, and one must not overlook the fact that at the time an investigation is commenced the extent of and method adopted in perpetrating the fraud are not known. Those matters are just what the investigator has been appointed to discover.

General principles should be followed together with the detective instinct. Here "bloodhound" qualities are more useful than those of the "watchdog." Much valuable help can be obtained from the reading of good

detective literature and from points in actual fraud cases that have come to light.

At this juncture a brief review of a few notable cases will not, it is hoped, be out of place. The main difference between the two types of fraud will be borne in mind while doing so.

The Farrow's Bank case was one where there was a bolstering-up of the position without enrichment of the directors responsible for the false accounts. The procedure was to write up all investments which they had made in other companies, to an extent considerably in excess of what might be regarded as the true values, and to carry such appreciation to their profit and loss account, as if it were a profit. The auditor, as well as the directors, became a compulsory guest of His Majesty subsequent to the failure, owing to the fact that he had never exercised the functions of an auditor in a proper manner, and, indeed, at the trial endeavoured to demonstrate that his method of presenting these accounts was a correct one. It is perhaps only fair to add that the auditor was not a member of any of the leading bodies of professional accountants.

An example of a rather different kind is one where there was a definite enrichment of some of the persons concerned, as in the City Equitable Assurance Co. case. It appeared that the general manager of the company had borrowed from the company the sum of £110,000 without any of the directors, other than the chairman, becoming aware of the fact. Of this amount some £96,000 had been obtained by means of cheques signed by some of the directors for what appeared to be normal business purposes. They were, of course, unwilling confederates. It has been said that the most difficult thing to find anywhere is the honest participator in a fraud. However upright a person may be, however much he

may be opposed to the idea of being a participator in a fraud, if he is careless in the execution of his duty he is in danger of being regarded as a confederate.

In the case named the cheques were drawn in respect of salary and advances on account of commission. The auditors on one occasion found that the manager had overdrawn his salary and commission to an amount of £15,000. A loan to the manager was then sanctioned for £15,000, for the purposes of buying a farm, and the deeds were to be deposited with the company. The chairman told the auditors that those shares had been so deposited, when, as a matter of fact, the general manager had pledged those shares to his bank. The chairman must, of course, have known that such a statement was untrue.

The auditors ultimately drew attention to the loan of £96,000 to the manager. The chairman at a subsequent board meeting produced an agreement which gave the general manager the right to draw amounts making £110,000 in all, and this loan of £110,000 was to be paid out of commissions which were due to him, with the proviso that if the company went into liquidation there should be no claim upon the general manager; and, further, if this £110,000 had not been recovered in 13 years out of the commissions due to him, the balance was to be written off. It subsequently transpired that at the board meeting where this agreement was passed, the chairman merely explained to the board that this was a new agreement relative to the salary and commission of the general manager, and the directors never saw the agreement, for though it was produced by the chairman, who held it up, no one read it, and it was passed for the seal of the company to be placed upon it.

This company also resorted to a very reprehensible

kind of "window dressing." Many companies at times resort to a certain kind of "window dressing." There are two forms. The first is a legitimate form, such as may be practised in a financial company with a view to showing a bigger ratio of cash reserves to liabilities. This can be achieved in various ways, as, for instance, when a company has a number of debtors and persuades those debtors to accept bills, thus converting sundry debtors into bills receivable, and possibly into cash. There can be no objection to such a procedure, because it is merely changing one form of cash into another, perhaps a more convenient form. The second form of "window dressing" occurs when the true position is hidden by a series of mythical transactions. This is a matter of a different nature.

The firm of stockbrokers who acted for the City Equitable Assurance Co. had, as their senior partner, the chairman of the company, and at one time they owed the company some £900,000. In order to make the liquid resources of the City Equitable Assurance Co. appear better, the stockbrokers purchased from a firm of bankers £300,000 worth of British Government Treasury Bills, and from another firm they purchased £200,000 of National War Bonds for the account of the City Equitable, which thus showed £500,000 of additional Government securities in its balance sheet. These purchases were actual transactions. The firm of stockbrokers did not take delivery of the Treasury Bills or the National War Bonds; they left them with the banks from which they had purchased them, as security. They did not pay anything for these bonds and bills, nor did they take delivery, and the banks simply held them for their account until such time as the money was forthcoming to pay for them. The purchases took place one or two days before the close of the company's

financial year. After the turn of the year they promptly sold them back to the bank from which they had bought them. That type of "window dressing" is to be deprecated.

Fraud is sometimes perpetrated by the deliberate manipulation of the values of stocks. There are many instances on record of this type of trick. The well-known case of the Kingston Cotton Mills Co., referred to elsewhere in this volume, is one good example.

One reason why stocks may be undervalued with a view to making the profit appear smaller than it is, and thus causing a lower dividend to be declared than is really justified with the resultant fall in the market price of the shares, arises because the perpetrators think more of their own personal interests than of those of the shareholders. They may thus be able to buy large quantities of shares at a nominal price, and in a subsequent year reverse their line of action, i.e. overvalue the stocks, show a greater profit than that made forcing up the price of shares, and then unload their holdings at a very big profit to themselves.

Fraudulent manipulation of stock values is not a new idea, nor is it uncommon. More than half a century ago there was the Millwall Dock case, involving a misrepresentation of £230,000, while more recently there was the Belgrave Cotton Mills case, in which a total loss of £350,000 was reported by the liquidator to have been caused almost solely by the inflation of stock values. The actual stock books had been entered up mainly by the late managing director of the company, and in all cases were certified by him as correct. Inflation had been carried out in three ways—

1. By making entries in the stock books of cotton not in existence.
2. By overstating weights of stock actually in the mill.

3. By valuing cotton considerably in excess of its value.

In addition, debts actually owing by the company were treated as assets.

Stocktaking Not Auditor's Duty.

It is not an auditor's duty (unless specially commissioned to do so) to take stock, and it is obvious that without doing so the misstatements under (1) and (2) above would not ordinarily be discovered by an auditor. As is pointed out in the observations relating to the Kingston Cotton Mills case, if a rough check were made by adding purchases and manufactures to opening stock and deducting sales less approximate gross profit, a closing stock value not materially different from the real figure based on an actual inspection and valuation at cost would be ascertained. Any appreciable difference between such approximately correct sum and that shown by the firm's officials should be inquired into. It certainly would be so treated by an investigator, but in the judgment in the Kingston Cotton Mills case it was stated that the failure to make this superficial and simple test, which would undoubtedly have brought the errors to light, did not amount to a neglect of duty on the auditor's part.

Another method of juggling with stocks is to hold back invoices for, and so omit, purchases, which would be ultimately passed to the trading account. This procedure is difficult to detect because, in some trades, it is a custom to deliver well ahead of the invoice date where periods of credit cannot be extended, and it is desired to get an order, and it sometimes happens that a firm is prepared to post-date an invoice so that the period of credit will run from the date of the invoice and not the date of delivery.

Notwithstanding the difficulty which an ordinary auditor may experience in detecting innocent or fraudulent manipulations of this kind, no leniency would be allowed to an investigator.

Finance Corporation Fraud.

Another case worth recalling for the points it introduces is that of the Liverpool Globe Finance Corporation. In that case Whitaker Wright had several companies under his control, and there were more ways than one in which he manipulated profits. In the first place, for each of his companies he had a separate firm of auditors; and in the second place, the accounting periods of the different companies did not end on the same day. His schemes would not have worked if they had. In order to get over many of his difficulties he changed the financial years of his companies as he wished. For instance, in one year, if he had closed his accounts on 30th September, he would have shown a loss of £1,600,000, so he continued business and finished on the 8th February in the next year, during which time he had been able to manipulate stocks to show a profit. One of his methods of "window dressing," however, was rather ingenious. He borrowed money from one of the subsidiary companies to swell the cash for the one which was falling due for audit.

This was worked on the simple but ingenious plan that a cheque would be drawn by the lending company at the end of the old year and brought into the books of the borrowing company. Repayment, dated even on the first date of the borrower's new financial period, does not deplete its bank account in the past period, and thus an independent certificate as to the company's account with the bank does not show up the transaction.

Ingenious Fraud on a Bank.

The following is an ingenious method (which has actually been worked) of fraud on a bank. A customer of the bank had an interview with the manager, and pointed out that he had had an account there for many years and that there had never been a credit balance of less than £1,000. Nevertheless, whenever a cheque was presented at the counter for payment, the cashier always referred to the ledger. After being a good customer for so long he considered their action reflected on his credit standing, and stated that if such practice did not cease he would remove his account to another bank. He went on to tell the manager that he had a deal at the present moment which would ultimately give him big profits. An open cheque for £800, drawn in favour of a certain individual, would be presented, and if the cashier referred to the ledger as usual before paying, his (the customer's) standing would be lowered in the payee's eyes and business would be lost. The bank manager agreed that the cheque should be paid without question, and gave instructions accordingly. Just before closing-time next day, six men simultaneously presented a cheque each for £800 to different cashiers, and each was paid. Neither presenters nor customer have since been found.

Another Bank Fraud.

Another interesting case is that of the noted gentleman who defrauded a London bank of several thousands of pounds, and actually had the audacity to tell them he was doing it, but they did not know at the time.

One day a number of branches in the south of London received a letter of advice from a northern branch saying their very valued client, Mr. D. S. Windle, was moving into the district, and they had the pleasure of

transferring £1,200 to the credit of Mr. Windle. They further stated that as Mr. Windle was purchasing property he would need within the next 24 hours or so a considerable amount in cash. Within an hour of the bank opening, the alleged Mr. Windle appeared, established his identity, drew cheques for varying amounts between £500 and £800, walked out, stepped into a cab and drove to the next branch. This went on until he had been in a number of branches; then, thinking that the cab driver was getting a bit suspicious, he ordered him to drive to the head office of the bank, in Lombard Street, informing the cab driver that he was the bank inspector, and said he would often engage him. He walked into the bank and out by another door. It turned out that that gentleman had even signed the cheques "D. S Windle," with no stop after the "S". When a man can swindle a bank for thousands of pounds and tell them he is doing it, he comes in the category already referred to of those capable of much.

Share Transfer Frauds.

Distinctly different circumstances may cover frauds of the same kind in principle. These include share transfer cases. The recent case of Hatry and his confederates, perpetrated on a colossal scale, is so well known to readers of this book that details need not be set out here. Two other cases not so great in amount but perhaps more ingenious in arrangement, and certainly more curious so far as their discovery is concerned, are those concerning a large British railway company and a firm of merchant traders in London. In the railway case a clerk in the Registrar's Department got a haul of £80,000, so it was reported, before being caught. And the discovery was a most peculiar one. The defrauder gave instructions

to stockbrokers to sell shares which the shareholders themselves had no intention of selling. Before the war it was no uncommon thing for the secretary or registrar genuinely to be asked to dispose of shares and to give instructions to sell stock. The contract note would be sent to the secretary of the company, who would send it on to the shareholder who was realizing. In the railway case the registrar would receive the share transfer, forge the shareholder's signature, and certify the transfer, send it to the stockbroker for delivery, and receive the cheque, which he pocketed. This fraud came to light in the following way.

The general manager of the railway company was on one occasion seeing off a certain member of the peerage from King's Cross Station when a person, whom the general manager knew to be a clerk in the Registration Department, walked along the platform, and he was surprised to see his lordship bow to this clerk. His curiosity being aroused, he asked the peer to whom it was he had bowed, and was greatly astonished to learn that the person he knew to be a clerk, earning some £2 10s. per week, was famed for his delightful dinners and his splendid wines. Subsequent investigations showed that the railway company had been paying for this entertainment for a considerable period of time.

In the other case, the secretary always handled what purported to be the old share certificates, and he pretended to cancel them. He defrauded the company of £20,000. The discovery was almost as singular as was that of the railway fraud, but was very different.

The managing clerk to the auditors of the firm was a man who said he never made a mistake. A clerk working on this audit came across an alteration of the figure of unclaimed dividends, an entry made by this

managing clerk, and he promptly chaffed the managing clerk on his slip. The managing clerk could not recollect any such alteration, and proceeded to make inquiries, and the fraud was ultimately brought to light.

Avoid Becoming Mechanical.

While carrying out an investigation of fraud, one must avoid becoming "mechanical" and submerged in the detailed checking, if such be needed, leading up to the disclosure, and one must be ever alert, for a clue may arise at any moment.

Imagination is an asset of very great value. The possibilities of fraud should be thought out in connection with the case under review.

The Report.

The report on the conditions, extent of fraud, and suggested changes in the system of accounting and administration requires an ability to put into words in suitable form the result of the application of the accountant's technical skill to the books and records in question.

Reports on investigations of this type generally open with a few preliminary observations and follow on with a short historical sketch of the circumstances leading up to the subject under review; the present system of accounting and administration, with the weak points prominently brought to light; the methods practised in the fraud, the extent of the defalcations and their effect generally; the system of audit (if any) in operation, drawing attention to its weaknesses in not making fraud extremely difficult, if not impossible; and finally, conclusions and recommendations.

CHAPTER XI

INVESTIGATION OF THE AFFAIRS OF A COMPANY WHERE FRAUD IS ALLEGED, AND IN CASES OF LIQUIDATION

THE circumstances in which an investigation of the affairs of a company becomes necessary arise out of action taken by shareholders while the company is carrying on business as a going concern, or in consequence of an order of the Court for the compulsory winding-up of the company. During the continuance of a business under the control and management of the directors, shareholders holding not less than one-tenth (or in the case of a banking company, one-third) of the shares issued, or in the case of a company not having a share capital, on the application of not less than one-fifth in number of the persons on the company's register of members, may, if they have good reasons for demanding an investigation, apply to the Board of Trade to appoint one or more competent inspectors to investigate the affairs of a company and to report in such manner as the Board may direct. A company may itself by special resolution appoint inspectors to investigate its affairs, and to report in such manner and to such persons as the company in general meeting may direct.

Inspectors appointed by the Board of Trade or by special resolution, have power to inspect all books and documents in the custody of the officers and agents of the company, and to examine on oath the officers and agents of the company in relation to its business. Legislation attaches considerable importance to these provisions, and the powers of the inspectors in regard

to enforcing production of books and documents, and answers to questions have been strengthened by the Companies Act, 1929.

Under Winding-up Order.

When an order of Court is made for the compulsory winding-up of a company, an investigation is necessary, because the Official Receiver, who becomes provisional liquidator, is required by Statute to submit a preliminary report to the Court as soon as practicable after receipt of the statement of affairs—

(a) as to the amount of capital issued, subscribed, and paid up, and the estimated amount of liabilities and assets; and

(b) if the company has failed, as to the causes of failure; and

(c) whether in his opinion further inquiry is desirable as to any matter relating to the promotion, formation, or failure of the company or the conduct of the business thereof.

The Official Receiver may also, if he thinks fit, make a further report, or reports, stating whether in his opinion any fraud has been committed by any person in its promotion, or by any director or other officer of the company in relation to the company since the formation thereof, and any other matters which in his opinion it is desirable to bring to the notice of the Court. The Court may, after consideration of the report, direct that any person who has taken any part in the promotion or formation of the company shall be publicly examined. These provisions do not apply to a voluntary winding-up, but the Court may make an order for compulsory winding-up, after a voluntary winding-up has commenced, if it can be shown that a searching investigation is needed. The penal consequences of

frauds and offences by officers of companies which are in compulsory or voluntary liquidation are set out in sections 135 to 137 of the Companies Act of 1929. The Companies Act, 1929, section 135, provides that the inspectors have power to inspect all books and documents in the custody of the officers of the company, and to examine on oath the officers and agents of the company in relation to its business, and sub-section 5 of that section provides that—

. . . if any officer or agent of the company refuses to produce to the inspectors any book or document which it is his duty under this section to produce, or refuses to answer any question put to him by the inspectors with respect to the affairs of the company, the inspectors may certify the refusal under their hand to the Court, and the Court may thereupon inquire into the case, and after hearing witnesses . . . punish the offender as if he had been guilty of contempt of court.

As regards inspectors appointed by special resolution passed by the shareholders, section 137 of the Act of 1929 provides that such

. . . inspectors shall have the same powers and duties as inspectors appointed by the Board of Trade, except that instead of reporting to the Board of Trade they should report in such a manner and to such persons as the company in general meeting may direct. . . .

and that

If any officer or agent of the company refuses to produce to the inspectors any book or document which it is his duty under this section so to produce, or refuses to answer any question which is put to him by the inspectors with respect to the affairs of the company, he shall be liable to be proceeded against in the same manner as if the inspectors had been inspectors appointed by the Board of Trade.

When considering one's line of action, attention should be given to any allegations which have led to the holding of an investigation.

Knowledge of the Provisions of the Companies Acts.

It need hardly be stated that a person undertaking an investigation of a company ought to have a sound knowledge of the law relating to companies, including the provisions of the recent statutes. In addition he should be acquainted with the methods of promoting and forming companies, and of the duties of directors, secretaries, and other company officers.

Investigations of the affairs of a company must be divided into two parts, viz.—

1. The examination of documents and books;
2. The examination of persons, viz. directors, secretary, and other officers.

Starting the Investigation.

As to which section should be taken first there is diversity of opinion quite apart from the question of convenience. It is thus suggested that the decision should be made after consideration of the particular circumstances of the case. The cause of the inquiry is an important factor in this connexion.

Documents.

Where circumstances properly render it desirable, the examination of the documents and books may first be tackled. This generally conduces to economy in time, the reason being that the persons who have to submit themselves to questioning may genuinely not always be able to recollect the details of important events which may have occurred years ago, and unless the examiner is in a position to refer them to the relevant books or documents, the examination may be very laborious and protracted.

In favour of reversing the order and performing the

examination of persons before the books, it is contended that individuals should first be questioned and their statements taken down and signed by them. The main idea of this is to prevent their being able to change their tales if inspection of the books and documents should make it advisable for them to do so in order to avoid later having to admit perjury.

Examination of the persons before making a scrutiny of records, books, etc., does not in any way reduce the value of an examination of such individuals after the books, as a further examination should be embarked upon if necessary.

As a first step in the examination of documents, those filed at Somerset House with the Registrar of Companies may be looked at. This involves a visit and the payment of one shilling search fee. These documents should enable one to ascertain—

The date of incorporation of the company.

The nominal capital, and how divided.

The objects and powers of the company as stated in the Memorandum of Association.

The powers of the directors and the regulations of the company as stated in the Articles of Association.

The names and addresses of the directors at the date of incorporation of the company, and any subsequent changes in the directorate.

The terms of the prospectus issued to the public inviting subscriptions for shares or debentures.

The terms of any contract or contracts under which shares have been agreed to be allotted to vendors or others as fully or partly paid-up for a consideration other than cash.

The terms of the reports to the statutory meeting.

The amount of capital issued, subscribed, and paid-up, the amount of underwriting commission paid, and

particulars of any mortgages and charges on the property of the company.

The contents of the statement in the form of a balance sheet which will be a certified copy of the last balance sheet which has been audited by the company's auditors, together with a copy of the auditors' report thereon.

The terms of any special resolutions, etc.

Contracts.

These documents should be carefully examined and all important facts noted. An epitome of contracts should be prepared, and while extracting information one should satisfy oneself that statutory requirements have been fulfilled in all respects. Contracts with the vendors of property acquired by the company, and contracts with promoters, directors, managers, or other officers should be specially scrutinized. Such contracts may, on investigation, lead to the discovery of secret profits derived by promoters, directors, or others. Sometimes, but not always, these secret profits are intentional.

The information obtained from the inspection of the documents on the Registrar's file should be constantly borne in mind in proceeding with the investigation. Especially those relating to the objects for which the company was formed, the parties to and terms of any contracts of sale and purchase, the regulations as to the qualification of directors and the conditions in which the directors might proceed to allotment, etc. The terms of the prospectus should be very closely examined to see that the provisions of sections 34 to 38 and Schedule IV of the Companies Act, 1929, have been complied with, and that all statements of fact set out in the prospectus are true. Statements of opinion are

of less importance. In illustration of what is here meant it may be found that the directors may have expressed the opinion that the prospects of the company are so good as to justify them in believing that the company may earn very large profits, without adducing any evidence to support their opinion. The public must be presumed to take unsupported opinions of this kind at their face value. If, however, the directors state that the past annual profits of the business to be acquired have been sufficient to pay a dividend of so much per cent on the amount of capital proposed to be issued, the statement must be capable of verification, or the directors will incur the risk of an action for damages for misrepresentation. The prospectus is obviously a most important document, as applications for shares are generally made upon the basis of the statements contained therein. Every statement of fact should therefore be tested and verified.

Inquiries should also be directed to discovering, if they exist, any instances of non-disclosures of material facts, or, as already mentioned, of undisclosed profits by promoters, directors, or others who stand in fiduciary relation to the company.

Minute Books.

Having finished with the extractions from the file at Somerset House, attention may advantageously be directed to the records and books of the company.

The minutes of the directors' and shareholders' meetings should be referred to and notes made of important resolutions, especially those relating to the allotment of shares, the adoption of the purchase contract, the payment of the purchase consideration, and the allotment of shares for a consideration other than cash. It is important to see whether or not terms of

contracts referred to in the prospectus have been varied without the approval of the statutory meeting of shareholders, and that the conditions as to the minimum subscription on which the directors might proceed to allotment have been fulfilled.

The minute book of a company should provide a valuable source of information as to the history and conduct of the company and its affairs.

Documents Issued to Shareholders and to the Public.

Documents issued to shareholders and to the public generally (including the prospectus) should be scrutinized. From these will be seen inducements offered to persons to invest in the company either as original applicants for shares or as subsequent purchasers in the open market. In this category might also be placed balance sheets, together with such other relevant documents as are in existence. Where definite statements have been made their accuracy should be tested with a view to ascertaining if there have been any misrepresentations.

With regard to the extent to which documents such as balance sheets which have been audited and certified by professional accountants may be taken as correct, the discretion of the investigator should be used in the light of the particular circumstances. The auditors have had access to the books and papers of the company, and have presumably been furnished with all necessary information and explanation required from the officers of the company. They have satisfied themselves that the books show the true financial position of the company, and that the balance sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best

of their information and the explanations given to them.

At this juncture it seems appropriate again to lay emphasis on the fact that an investigator is in a different position from an auditor. He is not accorded the latitude that ordinarily is allowed to an auditor. The latter is justified in believing tried servants of the company and in assuming that they are honest, provided he takes reasonable care. If he discovers anything calculated to excite suspicion he should certainly probe it to the bottom, but he is not bound to be a detective. As a rule the auditor enters upon his duty without any grounds for suspicion and without any reason for doubting the honesty of the directors and officers of the company.

The position of an investigator is different. It is generally the reverse. He usually enters upon his task in an atmosphere of suspicion and doubt. Allegations of misconduct or irregularity in the promotion or formation of the company or in the conduct of its affairs have perhaps started an agitation amongst the shareholders, culminating in the appointment of one or more competent inspectors to conduct an investigation; or the company has been ordered by the Court to be wound up. This implies a failure, the cause of which demands investigation, and the appointed person is expected to perform the task thoroughly. In such circumstances it may be incumbent upon him to conduct the inquiry to verify the accuracy of all documents issued by the company to its shareholders, or to the public, because, if dishonest or irregular practices have been resorted to by directors or officers it is possible and quite probable that elaborate and cunning devices have been used to deceive not only the shareholders and the public, but also the auditors. It may, therefore, in some cases be

considered necessary to test the accuracy of items in the balance sheets in the light of facts disclosed during the investigation.

Valuations of Stock-in-Trade and Other Assets.

If there is anything wrong with a balance sheet the valuations of assets are likely to be affected. Though the company's auditors may have certified the balance sheet as far as they are legally required to do so, it must be borne in mind that an auditor is not a valuer of fixed assets, nor is he even responsible for substantiation of the figures relating to stock. Valuation of land, buildings, machinery, plant, and the like should be made by a competent, independent valuer. With regard to stock it may reasonably be regarded as the duty of an investigating accountant to verify both quantity and value; quantity by inspection, and value by reference to invoices for cost price and invoices and other evidence for current market value.

That no reliance should be placed upon figures certified by the manager or high official and incorporated in a balance sheet certified by a professional accountant is evident from the case of the Kingston Cotton Mills Co., which was decided in the Court of Appeal so far back as 1896. In that case the auditors were held not to be under any obligation to perform even the most superficial scrutiny of stores records, let alone be responsible for the accuracy of either quantity or value of stock certified by a responsible member of the concern of whom they were auditors.

The manager had deliberately overstated the stock in hand to bolster-up the profits shown by the books. The company was a dividend paying concern, and the defrauder had a large holding of shares which he desired to unload by selling in the open market. He

knew that the higher he valued the stock the larger would be the balance of profit shown by the books; higher dividends would be declared, and a rise in the market price of the shares would follow. Having adopted this policy for two or three years, and having sold a large number of shares to the public at profitable prices, he retired. When the next stocktaking was effected and the stock was valued on a proper basis the effect on the accounts was disastrous, and an investigation was demanded by the shareholders. It so happened that the stock consisted mainly of heavy materials, and the inquiry which followed involved a comparison of each item of stock and its stock value with the cost of the item as shown by the invoices. It was an elaborate and difficult inquiry, but the delinquent was found guilty and sentenced to a term of imprisonment.

Transactions With Allied Companies.

Care should be taken in investigating any items falling in this category. Cases such as the old ones in which Whitaker Wright and Jabez Balfour were concerned still possess some points of interest, and the method adopted by those persons may advantageously be studied by all investigating accountants. A more recent one which should be thoroughly understood is that of Clarence Hatry and his confederates. The last-named is so well known that little need be said about it in these pages. An outline of the earlier frauds may perhaps be more justified.

Mr. Whitaker Wright achieved considerable success in the flotation of gold-mining companies situated in Australia, and, as a company promoter, he at one time stood very high in the estimation of the investing public. Consequently, he had no difficulty in inducing

the public to subscribe for shares in each of a group of companies which he formed to acquire various assets, including interests in gold-mining properties. He became director of three of the larger and more important of these companies, and embarked upon very extensive speculative dealings in the shares of these and other companies which he had promoted. Sometimes these dealings were in the name of one company and sometimes in the name of another, and sometimes shares in one company were sold to another company in the same group, and vice versa. Speculative dealings on the Stock Exchange were carried out on a very large scale and resulted in very heavy losses, which brought about the failure of the three companies referred to. One transaction at least is of interest in connection with the scrutiny of balance sheets. The balance sheet of one of the companies was made up to 5th December, 1900, but just before that date the company had speculative Stock Exchange operations outstanding amounting to over £1,500,000. All these commitments were, however, excluded from its balance sheet by transferring the whole of the operations to another company, i.e. the liabilities to brokers on the one side and the shares at the contract prices on the other. This transfer was confirmed by formal resolutions recorded in the minutes of each company. On 13th December the whole of the transactions were written back, and the liabilities and assets re-transferred to the first company. The explanation given was that the transfer from that company had not been acquiesced in by the brokers, and it therefore became necessary as a matter of book-keeping, to re-adjust the entries by writing them back. But in the meantime the balance-sheet of the first concern had been issued and, as these huge speculative commitments had been

eliminated therefrom in the way described, it could not be said to disclose the true financial position of the company. The auditors, before signing the balance sheet, were led to believe that the transfer of the commitments was *bona fide*, and in that respect were deceived.

Another fraud occurred where two men were directors of a group of companies. One of the businesses was that of a printer, which did work for a firm of machine makers, some of whose invoice headings were kept back and filled up for a total of £15,000 for plant, supposed to have been supplied to another member of the group which had been carrying on business for a number of years. The invoices were properly entered in the books of the supposed purchasing company and cheques were drawn in payment. Investigation disclosed the fact that the firm of machine makers supplied the plant and did not receive any part of the £15,000. The cheques had been made payable to bearer, and the £15,000 had been credited in equal parts to the private banking accounts of the two directors.

Examination of Persons.

In performing this phase of an investigation the accountant will proceed to examine the directors, secretary, and other officers and agents of the company for the purpose of confirming any facts in regard to which there may be any question, and for elucidating and explaining any points which have arisen during the inquiry. The effectiveness of this part of the investigation will depend upon the skill, judgment, and tact exercised by the examiner.

Public Examination of Persons.

Where an investigation is being conducted in consequence of a compulsory winding-up order, and where

any matter is reported or referred to the Director of Public Prosecutions or Lord Advocate under section 277, and he considers that the case is one in which a prosecution ought to be instituted and, further, that it is desirable in the public interest that the proceedings in the prosecution should be conducted by him, he must institute proceedings accordingly, and it is the duty of the liquidator and of every officer and agent of the company, past and present (other than the defendant in the proceedings), to give him all assistance in connection with the prosecution which he is reasonably able to give.

For the purposes of this subsection, the expression "agent" in relation to a company is deemed to include any banker or solicitor of the company and any person employed by the company as auditor, whether that person is or is not an officer of the company.

The Company's Accounts.

Section 274 (1) of the Companies Act, 1929, should be borne in mind, as it may be necessary to determine whether or not proper books of account have been kept. The subsection just named provides that—

If where a company is wound up it is shown that proper books of account were not kept by the company throughout the period of two years immediately preceding the commencement of the winding-up, every director, manager, or other officer of the company who was knowingly a party to or connived at the default of the company shall, unless he shows that he acted honestly or that in the circumstances in which the business of the company was carried on the default was excusable, be liable on conviction on indictment to imprisonment for a term not exceeding one year, or on summary conviction to imprisonment for a term not exceeding six months.

For the purposes of this section, proper books of account shall be deemed not to have been kept in the case of any company if there have not been kept such books or accounts as are necessary to exhibit and explain the transactions and

financial position of the company, including books containing entries from day to day in sufficient detail of all cash received and cash paid, and, where the trade or business has involved dealings in goods, statements of the annual stocktakings and (except in the case of goods sold by way of ordinary retail trade) of all goods sold and purchased, showing the goods and the buyers and sellers thereof in sufficient detail to enable those goods and those buyers and sellers to be identified.

Report.

On conclusion of the investigation the investigator must make a report, the form of which will depend partly on the circumstances and partly on the judgment of the examiner. It is a good plan to state facts in historical order, and deal specially with matters which have formed the subject of allegations of misconduct.

Where the investigation is by inspectors appointed by the Board of Trade the report must be sent to the Board of Trade, who must send a copy of it to the registered office of the company and a further copy to the applicants for the investigation, if the latter request one. The report must be written or printed as the Board directs.

CHAPTER XII

COMPULSORY ACQUISITION OF LAND AND BUILDINGS

PUBLIC bodies may in certain circumstances acquire land compulsorily. Investigation of the claims made for compensation is a task that has to be accomplished. It is the object of this chapter to review the position and to suggest a basis for its determination.

Powers are given to local authorities as follows—

1. **Urban District Councils and Town Councils in their Capacity as Urban Authorities.** The Public Health Act, 1875, sections 175 and 176, provide that land may be acquired by agreement or compulsorily, following the observation of a prescribed legal procedure.

2. **Town Councils as Municipal Corporations under the Municipal Corporations Act, 1882.** Provision is given by this Act for the acquisition of land (in the authority's area) not exceeding five acres, without consent, and in the case of land for purposes not authorized by the Act or for which no licence is possessed, such land may be acquired with the permission of the Ministry of Health. The Act contains no provision for the acquisition of land other than by agreement.

3. **County Councils.** The Local Government Act, 1888, enacts that the provisions relating to the acquisition of land of the Public Health Act, 1875, shall apply to county councils.

4. **Rural District Councils.** The provisions of the Public Health Act, 1875, sections 175 and 176, also apply to rural district councils in connection with land acquisition.

5. **Parish Councils.** These authorities may for any of their purposes acquire land by agreement, and other

than by agreement after the county council (or, failing which, the Ministry of Health) have granted compulsory powers. Certain legal formalities have to be complied with.

6. **Parish Meetings.** A county council may invest a parish meeting with the powers relating to acquisition of land, possessed by a parish council.

(a) LAND

Basis of Assessment.

Compensation in respect of land compulsorily acquired for public purposes is assessed in accordance with the provisions of the Acquisition of Land (Assessment of Compensation) Act, 1919, which provides as follows—

1. Where there is any dispute as to the amount of compensation or apportionment of rent under a lease, the matter shall be referred to arbitration in manner provided.

2. The Act applies to all existing enactments except those relating to the assessment of land acquired for the purpose of Part I and Part II of the Housing of the Working Classes Act, 1890, and of land acquired under the Defence of the Realm (Acquisition of Land) Act, 1916.

Rules for the Assessment of Compensation.

In an arbitration the official arbitrator must act in accordance with the following specified rules—

(a) The value is to be fixed on the basis of what a willing seller in the open market might expect to realize.

(b) No allowance may be made in consequence of the acquisition being compulsory. But this does not affect the assessment of compensation for disturbance or other matter not directly based on the value of the land.

(c) Special suitability of the land for any purpose may not be taken into account if it is a purpose to which it could only be applied in pursuance of statutory powers or for which there is no market apart from the requirements of a government department or local authority. But a *bona fide* offer of purchase before the passing of this Act must be taken into consideration.

(d) Where the value of land is increased by reason of its use in any manner which could be restrained by any court, or which is contrary to law, or which is detrimental to public health, such increase may not be taken into account.

(e) Compensation may be based on a reasonable cost of reinstatement where the land is used and would otherwise continue to be used for a purpose for which there is no general demand.

Where compensation is being paid to an owner-occupier, it may only be given in respect of his disturbed tenancy. No compensation is payable to him in his capacity as landlord.

Arbitration.

After the legal and financial officers' reports have been received by the council, an offer is usually made to the claimant in full settlement of his claim, and if this is not accepted, the clerk to the authority should apply for the appointment of an arbitrator. Where the matter goes to arbitration, it is customary to hand to the arbitrator on the morning of the hearing a sealed envelope containing particulars of the local authority's offer to settle. This is not opened until after evidence has been heard from both sides. Where the award exceeds the local authority's offer, the arbitrator generally makes the authority liable for all costs; where it is less the claimant is usually ordered to defray all costs.

(b) FREEHOLD AND LEASEHOLD BUILDINGS

A claim following notice of compulsory acquisition will probably contain the following items—

1. Compensation for the sale of the freehold or for the surrender of the lease or tenancy for the remainder of the period held.

2. Loss on fixtures or plant.

3. Loss on stock-in-trade.

4. Expenses of removal.

5. Damage to or loss of business.

Some Points to Observe in Determining Compensation.

If removal occasions little or no loss, compensation should be only slight, but in no case should it exceed the value of the goodwill of the business as a going concern in the open market. Each case must be considered on its own merits. The matters usually needing consideration are—

1. Nature of the tenancy—freehold or leasehold.

2. Suitability of the situation of the property.

3. Possibility of getting suitable alternative accommodation.

4. Nature of the business.

Claims are necessarily based on past results of the business in question. Thus, an investigation of the trader's books is necessary so that the nature of the profit on which the claim is based may be examined in detail. If a claimant was reluctant in the production of his books in support of his claim it would be detrimental to his interests if the case were referred to arbitration.

Examination of Claim.

The claim should be a detailed one, and to ensure this a form in which to make the claim, and setting out

the questions to be answered may advantageously be sent to the owner or lessee by the clerk to the authority. When returned the claim should be examined and verified. The title deeds should be examined by the authority's legal officer by arrangement with the claimant or his solicitor. The town clerk is responsible for the legal side of the matter, and the financial officer for the financial side, and both may be called upon to substantiate the statements in their report to the council before the official arbitrator if the matter goes before him.

The principal points to investigate when examining the claim are—

The Leasehold Interest in the property. The valuer should advise upon the fair letting value at the date of "Notice to treat."

Stock should be considered as to value. The alleged value in the claim should be compared with the book value for the current date and with previous years' figures. Compensation based on a forced sale should only be allowed where the tenant cannot remain in business for a period long enough to dispose of the goods. Where the latter is the case, removal expenses only should be adequate compensation.

Fittings and Fixtures should be inspected and valued. Reference to the book value and balance-sheet valuation should be made.

Removal Expenses. The claimant will probably have claimed on the assumption that no suitable premises are available in the neighbourhood, but the investigation officer should take the line that it is a case of disturbance to the business and not of destruction, and should include under this heading a sum to cover reasonable removal expenses and any depreciation to the stock caused by the removal.

Damage to or Loss of Business. This item will present more difficulty. At an early stage in the investigation it is well to arrange for an interview with the claimant on the premises which are to be acquired or which are to be temporarily injured by the carrying out of the improvement or work. In addition to obtaining information as to the class of business carried on by the claimant, and also viewing the premises, it will furnish an opportunity to ascertain what books of accounts have been kept and whether or not yearly trading and profit and loss accounts are prepared by professional accountants. If no accounts have been prepared it will be necessary to construct accounts from the information available. Information as to purchases can be obtained from the receipted invoices. Most traders keep their receipted bills. Careful inquiry would have to be made from the claimant as to whether he is in the habit of purchasing goods for cash, and if so, to what extent. The degree of trust to be put in the claimant will depend upon the way in which he has furnished information on other points when requested.

Herein lies the value of the power in an investigator to know, as it were by intuition, the degree of honesty of the claimant. Most traders keep some sort of record of their daily takings, even if only of a rough kind. It will be necessary to inquire whether amounts inserted represent the gross takings, or whether they represent the daily amounts left in the till after the ordinary expenses of the household have been met, for in many cases the claimant lives on his business premises. If the figures are net it will be necessary to inquire the number of his family and whether all his household and personal expenses are paid by cash, or whether part are paid out of cash and part from bank. If it is so, the takings will have to be suitably adjusted. Information

is then available for the preparation of the trading accounts. The commencing and final stock may reasonably be ignored, as in a business that does not keep books of account, the value of the stock may be taken as varying but little.

The gross profit may be calculated as a percentage on sales. Statistical information as to gross profits of former claimants in a particular trade is an invaluable test of accuracy of the statements of the claimant or of the presentation of all the invoices for purchases. Where a banking account is kept, this should be scrutinized carefully to obtain details of expense items which may have been paid by cheque.

If the claimant has more shops than the one which is the subject of the claim and, more especially if complete accounts for each business have not been kept, the greatest care will have to be exercised before accepting any statement as to the subdivision of the profits, as it cannot be taken that profits are made in strict ratio to turnover at the various branches.

Loss of Profit. The principal points which might affect the amount of compensation are—

(a) The possibility of the claimant opening business elsewhere, and particularly if he has secured or had offered other premises, their suitability and value from a business point of view.

(b) In examining the profit and loss account it should be seen that all expenditure has been charged, e.g. proprietor's own services, bad debts, etc., and all proper credit given for goods used personally by the claimant and his family.

(c) Accounts for past years should also be inspected in order that the condition of the business may be gauged, e.g. it may be decidedly on the wane.

(d) The usual compensation takes the form of from

one to three years' purchase of the average profits for the last three or five years.

(e) Unless the accounts for the various years have been certified by a reputable firm of accountants, the agreed computation of profits for income-tax purposes should be called for. Refusal to produce these would act as a warning that the actual profits were less than alleged in the claim made.

The Principal Matters Affecting Chief Financial Officers.

The principal matters connected with the acquisition of an undertaking that affect the chief financial officer of a local authority, are—

1. The date of purchase.
2. The assets to be acquired.
3. The liabilities to be taken over.
4. The method of fixing the purchase price.
5. The powers conferred on the authority.

The purchase price may be arrived at by mutual agreement or by the more costly method of arbitration.

It is important to note that in the purchase of an undertaking by a local authority no payment should be made for goodwill, as this does not as a rule arise, because—

1. The success of the undertaking is not largely dependent on the personnel of the selling company.
2. There is no competition to overcome. Customers must of necessity go over to the local authority.

CHAPTER XIII

EXECUTION OF CONTRACTS ON A FLUCTUATING PRICE BASIS OR AT COST PLUS PROFIT

THE kind of investigation dealt with in this chapter is that which consists of a careful and minute scrutiny of the books, accounts, contracts, and even the correspondence of a firm doing work for which payment is made on a basis to be adjusted with the fluctuations in market prices.

Inconstancy of Prices.

When market prices of materials and labour are not constant one cannot expect to obtain tenders at finely cut, competitive, definite prices. If one must have an out-and-out figure, it is only natural that the contractor will have to take into account the possible fluctuations in price of both materials and labour, including travelling expenses, National Insurance contributions, etc. If he thinks prices will rise he is certain to include in his estimate enough to cover them and to keep on the safe side, and if he has an idea that a fall may be expected he is not likely to prophesy a very great one for the purposes of his quotation. Pre-war stability in prices has not yet arrived. But it may be quite competent to obtain tenders, finely cut in price, but based on the current market rates, provided a clause is inserted in the agreement relegating all the vicissitudes to the employing party.

In a scheme of this description the contractor includes the profit he intends to make. Provided this is a reasonable sum, the employing party accepts the contract figure and undertakes to pay to him any legitimate

increase he may be put to in consequence of upward fluctuations in cost, and also reserves the right to deduct from the contract figure any sum by which prices fall below the standard in operation on the date of the tender.

Though there are probably fewer contracts let on this basis now than several years ago, the system still obtains.

Nature of the Agreements.

Though agreements of this nature vary considerably as between themselves and also between one employer and different contractors, they can all be classified under one or other of two distinct kinds. These two forms differ widely, and consequently call for a different method of attack when the inspection of accounts is commenced. It will thus be realized that a thorough knowledge of the terms of the contract in question is imperative by the persons about to investigate. A superficial acquaintance will not suffice. It must embrace the legal side as well as the financial and accounting aspects. At first this may seem superfluous, but a moment's reflection will reveal the fact that on many points the legal action that may be necessary is controlled by the result of the accountancy operations. One instance alone should be enough to illustrate this point. A clause may be present in the agreement giving the corporation power either to cancel the contract and claim damages for loss, or to let the initiative towards a premature termination emanate from the contractor himself in the event of default by the latter. The exact financial relationship between the parties will in many cases at the time of an impending breakdown determine whether or not it is economical for the employer to terminate it or to wait, and, figuratively speaking, let

the contractor file his own petition. Without this accounting information legal action is held up.

Types of Contract.

The two types of contract coming in this category are—

Type 1, which is an ordinary tender to complete the work specified for a fixed price, subject to variations in price to meet alterations in cost of materials and labour.

Type 2, which is one on a time and materials basis, i.e. where the employer pays the actual cost of the work plus an agreed profit.

Type 1 Contract.

The investigating accountant's duty consists principally in verifying the accuracy of the fluctuations in prices. Many clauses in the agreement have to be considered, e.g. it will probably be provided that no increase in market price may be taken on materials drawn from the contractor's own existing stock; that no increases in cost of plant are permissible; that *actual* advances in materials and labour only are allowed, i.e. no margin of profit on increases. But extra work done in excess of specifications will be paid for by refunding the actual prime cost of the labour and materials expended thereon, plus an addition of an agreed percentage of profit. Here it should be noticed that profit is allowed on extra work done but not on increased prices of work included in the contract. The reason for this is that profit on the work tendered for is included in the tender figure, while extra work forms, in effect, the subject of a new contract on which the builder is entitled to a reasonable profit. But the whole of the percentage named is not profit, as it includes all the administrative charges and use of plant, etc., of the builder on this extra work. The investigator must be

careful to ascertain that the contractor does not by accident or design charge these oncost figures up to the employer in an indirect way.

The principal clauses to be considered by the investigator will most probably be similar to the following—

Contract Price.

The amount payable is the contract price, subject to such additions and deductions as are specified below—

1. Variation in price to meet alterations in cost of materials or labour (including National Health and Unemployment Insurances and travelling expenses of the workmen).

2. That sufficient proof be given that the additions to the contract price are in respect of *actual* increases.

3. That increases are not due to any unreasonable delay or failure on the contractor's part to purchase.

4. That on a falling market care be taken not to purchase big stocks at high prices, but only immediate requirements.

5. That no increases are permissible on plant or scaffolding.

6. That no increases may be charged on materials taken from stock, even though the market price be enhanced.

7. That material taken from the contractor's stock shall not be charged out to the contract at a higher figure than current market price in cases where the market price has fallen.

8. That claims for extras (i.e. work in excess of that included in the contract and differing from advances in price) shall not be made unless the extra work and materials are authorized by the employer.

9. That such claim for extras shall be the actual cost of executing such extra work, plus an agreed percentage

on materials and labour, say, 10 or 12½, to cover administrative charges, etc.

10. That a clerk of works appointed by the employers be permanently on the job.

11. That the books and accounts of the contractor shall be open to inspection by the employer's duly authorized representative.

Starting the Investigation.

To verify these points it is necessary to inspect the receipted invoices representing the articles on which an increase has been made, and to compare these figures with the priced merchants' quotations (if any) for the supply of the necessary materials, when the tender was given, in order that only actual advances in prices shall be allowed. Where parts of the work are sub-let the quotations and invoices must be inspected, and it must be proved that any increases by the sub-contractor in his charge are actual increases to him and contain no margin of profit. On this question of profit a contractor is apt to calculate the percentage on the gross amount and not on the net or original figure, thus making profit on advances, in which case he would be favourably interested in the rises in market prices. Further, when something has gone up by a certain percentage, e.g. iron-mongery, say 25 per cent, or other materials not specially quoted for but based on the market rates ruling at the date of the tender, a builder is inclined to calculate the increase on the amount paid, which is obviously on 125 per cent instead of on 100 per cent. These are important points to watch.

Wages.

It is necessary to inspect the time-sheets duly certified by the employer's clerk of works or foreman to ascertain

that the number of hours on which the increase in wages is charged have been actually expended on the work in question. These will be traced to the cost account therefor as an additional check and to the financial books to prove that the amounts have actually been paid. The advances allowed on materials must only be on materials actually put into the work and appearing in the cost account. This emphasizes the fact that a mere inspection of invoices and quotations is not enough, and that investigation must be carried beyond that stage. Thus tracing the time and materials to the cost ledger and a comparison of the total debits with the bill of quantities will reveal whether or not the materials are all used up or whether the builder has quietly withdrawn surplus articles without giving credit to the cost account of the job, and incidentally to the employer. When credits are thus discovered care must be taken that the advanced prices are allowed on only the *used* portions. The dates of the actual purchases must be scrutinized in order to ensure that the increases are not due to unreasonable delay on the part of the contractor in making purchases, while the market was easier, and to show that they were not earlier purchases not relating to the contract in question. Care must be taken that none of the extra charge is on plant and scaffolding. It must also be ascertained that no head office or administrative charges are smuggled in as wages or materials. If the investigating accountant prepares a comparative list of prices of materials purchased by all the contractors doing similar work, some valuable data is available which will help to show why one can execute work cheaper than another; which are the contractors who are the keenest buyers and have thereby acted in the economical interests of the employer.

On the question of extras, i.e. work not included in

the original contract, proof of the sanction of the employer must be produced and the terms included therein ; or where a clause in the original contract covers such possibilities, the conditions thereof must be understood. The terms may be current market rates, though more often, and advisedly, day rates on a time-and-material basis. This means that the actual cost of labour and materials expended on the extra work must be traced through to the cost account, and that it represents actual cost plus the agreed small percentage added to cover supervision and administration charges.

Materials.

To the observant investigator additional methods of verification and sources of information will present themselves. Many of these, though forming only secondary evidence, provide most powerful clues to the confirmation of points and suspicions that have been present in the investigator's mind, but which he could not prove directly. These little observances rise in the course of the inspection, and as they differ according to circumstances, cannot be set out in the form of a rule. But one or two illustrations will emphasize the value of and the kind of evidence referred to. In examining the carriage and carting accounts, particulars of the journey should be demanded. In many cases this information already appears on the invoices. Any charges for carriage or cartage *from* the site denote that materials were taken away. One should ascertain *what* was removed and where it went, and see that full credit is given to the cost account and to the employer in respect of the goods taken away. Another example of information that may be gained in an indirect way is illustrated by the fact that when examining the books of a sub-contractor it may be noticed that in his credit

note-book, credit has been given in respect of returns or allowances. Of these the accountant should make a note, and he should see that due credit is given to the employer in the principal contractor's books.

The need to scrutinize sub-contractors' and merchants' accounts is more important than is at first apparent. Perhaps one of the most difficult to trace, and at the same time most likely to involve doubtful dealings, is the case where the contracting firm deals with traders *apparently* totally unconnected with themselves. In the sense in which a limited company is a separate entity, this independence is true, but there are many firms now registered and trading under different names, but in reality being simply the contractor's firm under the same management. This provides the builder with the means of selling goods ostensibly belonging to, or executing work by, an apparently independent merchant or sub-contractor. The transactions are made more genuine-looking by the rendering of invoices, etc., of different styles, though there are allied firms of this description having the same addresses and the same telephone numbers and telegraphic addresses printed on their official stationery. The danger of unscrupulous dealings by this means is obviated to some extent by including in the agreement a clause that every purchase involving an expenditure of, say, £100 or more, shall be submitted to at least three firms for tender of prices, and the quotations should be inspected by the investigator.

In order to obtain full benefit of falls in market prices, and also where the builder buys more advantageously than he anticipated, it is imperative that *all* accounts be scrutinized to see if there will not be deductions from the tender price.

It is essential for the investigator to inspect every invoice, and this is no light task. Were he an auditor, all

such documents would be produced most readily. In order to satisfy himself that *all* invoices are produced, the accountant must go back to the books of prime entry. He must work from the invoices received book, day book, or whatever happens to contain the opening history of the transactions. If the system of book-keeping is too primitive or deficient to include such books it may be necessary to work from the personal ledger for credit purchases and from the cash book for cash items. Then there is the difficulty of distinguishing transactions which refer to the job being investigated, from those concerning work being done for other parties. This makes it necessary in some cases to trace the purchases to the stores ledger and out again to the cost account in respect of the contract under review. Where the costing system is deficient one has to make the best of the "contract" and "work" accounts in the nominal ledger, and the personal account opened in the name of the employer.

Type 2 Contract.

The second type of contract, namely, one on a time-and-materials basis, differs considerably from that already reviewed. In these circumstances the position practically amounts to the employment direct of the contractor's workmen, with the contractor himself as manager of the work. The relationship is not exactly this, but it very nearly approaches it. The principal financial clauses in a contract of this description are similar to the following—

1. A basic price may be included as a guide to the ultimate approximate cost, or as the highest figure on which will be allowed the agreed percentage for profit, where the actual cost works out higher than the estimated cost.

2. The contractor pays current trade union rates of wages, etc.

3. That sub-contracts for sections of work not undertaken by the builder himself are agreed with the employer.

4. Possibly the employer may pay the contractor a proportion of the cost of the establishment of a dépôt or the provision of plant and other necessary equipment, provided such is used exclusively on the employer's contract, making provision for the taking over of this at an agreed price either by the contractor or the employer on the termination of the contract.

5. A sum of so much per unit completed, or a lump sum, will be paid to the contractor, which figure will cover all overhead charges and profit.

6. That all purchases shall, before being effected, be authorized by the employer.

7. That the employer shall have a clerk of works permanently on the job to pass and to certify the work done, and on whose certification periodical payments shall be made (up to a certain proportion) by the employer to the contractor.

8. That the books and accounts of the contractor shall be open to the inspection of the employer's duly authorized representative.

As in all cases, the mission of the investigating accountant is to safeguard the employer's interests by ascertaining that the terms of the agreement are adhered to. Clause (1), if only an approximate indication of the ultimate cost, needs no observations, but if it fixes the maximum figure on which the percentage for overhead charges and profit will be calculated the comments on it are included in those on the fifth clause. The second clause is verified by the pay-sheets, while the third is subject to comparison of the sub-contractor's

tender with the specifications supplied to him and with the employer's sanction to the acceptance of the sub-contract. This is quite simple, but it must not be overlooked that the sub-contract is a contract in itself, and as such will doubtless contain clauses dealing with alterations in prices varying with market rates, and involves investigation.

The points to look out for in clause (4) are that no item really being part of the establishment of the dépôt or the provision of plant and equipment, and falling solely on the contractor (except by agreement to the contrary), has been included as expenditure solely payable by the employer. The discrimination required here in connection with many of the more questionable items require considerable tact and careful dealing before a surcharge is decided upon. A moment's reflection will reveal how easy it would be for an unscrupulous (or careless) builder to charge items to his employer's account instead of to his own. An example will suffice to illustrate this point. A particular class of materials used in building may be the same as that used in providing plant or equipping the dépôt, etc. An effort may be made to charge both time and materials to the employer.

Clause (5), relating to the calculation of the sum allowed for profit and overhead charges, is worthy of comment. If the sum payable is a definite fixed amount it is perhaps better than a fixed percentage of profit being allowed either on a basic price or on the cost of the job, as in the latter case wasteful expenditure is encouraged. The fixed sum per unit, including head office expenses and profit, offers incentive to economy, though, of course, it necessitates extreme vigilance on the part of the investigator to see that no head office charges are smuggled amongst the items

for which the employer pays in full. The percentage on basic price or actual cost, if lower, may lead to discord, as the more economical and careful the builder may be, the less he is going to be paid. This acts as a penalty on the contractor who keeps down cost.

The Value of an Investigation.

The value of an investigation is not limited to the knowledge that the payments made are in respect of actual value received and that the employer's interests are to this extent safeguarded, but includes the benefit arising from the use of the ascertained cost as a base when effecting further contracts. Tenders can be compared with the known actual cost to the employer of the same work by the same (and other) contractors.

It would be an impossible task to mention every point to be looked for, in view of the fact that circumstances are different in every case. The special points to watch carefully should arise in the mind of the accountant as soon as he has grasped the peculiarities of the case under review. For instance, when he sees the charges in the books for insurance premiums he will call for the policies, and will see that if it be a cost-contract (i.e. Type 2 above), the agent's commission is duly credited to the employer and not retained as an extra profit by the contractor. The insurance policies will also cause him to see that any rebate due under the workmen's compensation insurance by reason of the total wages paid during the period being less than the figure on which the premium has been calculated, is duly credited. Though it may be considered by some to be outside his province, an investigator might reasonably make representations

that the books reveal that expenditure was being spread over as many houses as possible, while only a few were being finished. This might indicate that the contractor desired final cost figures per house to be delayed as long as possible for fear they should not count in his favour, and incidentally so that, in the event of a decision by the employing party to terminate the contract, he would have got under course of construction the maximum number possible in the hope that he would be allowed to complete those, even though he might not start any further ones.

It is advisable to make and to keep copious notes of all that transpires during the course of an investigation in order to be able to substantiate at any future time the statements certified. The notes should not be confined to actual figures, but should include a written account of any explanations received in reply to inquiries.

CHAPTER XIV

INVESTIGATIONS ON BEHALF OF PERSONS PROPOSING TO INVEST

THE present chapter deals with investigations on behalf of persons who propose to invest a substantial amount in a limited liability company or elsewhere.

There are certain considerations involved in investigations on behalf of persons who propose to finance businesses by advancing money to the existing proprietors whether by way of shares or loans.

General Points for Consideration.

These matters include the nature and situation of the business and the character and ability of the persons in whose hands lie the control and conduct of it. The object of the proposed agreement is to provide funds for the carrying on of the business, but however stringently the agreement may be drawn, it must be remembered that the control of the funds which one's client proposes to provide will be entirely in the hands of those who have the control and conduct of the business and in no way is his. The fullest possible information which can be acquired, should therefore be first obtained as to the nature of the business and the scope of its operations, and the technical knowledge and experience of the proprietors or directors, together with any information as to their character and their predecessors.

So far as the accounts are concerned the investigation should aim at ascertaining—

- 1 The earning capacity of the business.

2 The true position of affairs at the date of the investigation.

3 The causes which have operated to produce the shortage of capital by reason of which further money is required.

The ascertainment of profits will be done on the ordinary lines suggested in other sections of this book.

A very important matter which should not be passed by lightly is the security to be offered to the lender. If the borrowing party is a sole trader or firm of partners, it must not be overlooked that if a rate of interest varying with the profits be taken, a very carefully drawn-up agreement is necessary to ensure that the person lending the money shall not be liable as a partner coupled with the possibility of such person being a deferred creditor, in the event of the insolvency of the business.

It is therefore absolutely essential to take into consideration whether or not collateral security should be obtained in consideration of the proposed advance. And the nature and value of that which is offered should be subjected to very close scrutiny.

Where the borrower is a company, the security will generally take the form of debentures, in which case inquiry should be made to discover if there are any existing mortgages or charges which might have priority over that given for the proposed advance.

The provisions relating to registration of mortgages and charges should be fully borne in mind, as also other sections of the Companies Act, 1929, relating to this matter.

Especially should it be noted that under section 266 of the Companies Act, 1929, where a company is being wound up a floating charge on the undertaking or property of the company created within six months

of the commencement of the winding up shall, unless it is proved that the company immediately after the creation of the charge was solvent, be invalid except to the amount of any cash paid to the company at the time of, or subsequently to, the creation of and in consideration for the charge together with interest thereon, at the rate of five per cent per annum.

All factors which a prospective investor ought to know to enable him to exercise proper judgment as to whether or not he is satisfied with the security offered must be made known to him in the investigator's report.

1. Taking Ordinary Shares.

Where the inquiry is on behalf of a person who proposes to acquire ordinary shares in a limited company, either public or private, it should be ascertained exactly what voting rights he as holder of ordinary shares would have, i.e. will he have one vote no matter his holdings, or one vote per share held. Where a person intends to acquire a material interest in an existing company, it is essential that his voting rights should be protected.

A further matter to take into account is whether or not the investor proposes to become a director of the company, as if he does, his liability as such and his voting powers in that capacity need consideration. These points are important, especially if his proposed holding is a large one. Ordinarily he will only be entitled to one vote against a similar number for each of his co-directors, and he may thus be completely outvoted though his share capital is greater than theirs.

It may be desirable to make provision against this either by restricting the powers of directors to purely

administrative affairs and eliminating their ability to do anything which could affect the rights of shareholders, or by appointing as additional directors the purchaser's nominees in order that he may, through them, control the voting.

Other matters for consideration are—

(a) *The Transferability of Shares.* Restrictions if any on the transfer of shares should be inquired into. A private limited company must always have restrictions as to the transferability of its shares, the usual restrictions being that no transfers can be completed until assented to by the board of directors, but a public company need not have any such restriction, but very frequently does, and thus it should be seen that no unjust restriction is placed on the transferability of the shares, as it is possible that one's client may at some time desire to sell his shares, and might find a purchaser for that holding, and yet, under the regulations of the company, be prevented from completing his sale by restrictions on transferability.

(b) *The Powers of the Company to Issue Shares having a Prior Right.* One should ascertain whether the articles of the company permit the issue of shares which would, in certain circumstances, have prior rights to the ordinary shares, such as preferred shares, preference shares; and if so it may be desirable that the articles or regulations of the company be altered in such a manner that no such preferential issue can be made without the consent of the purchaser or his nominees.

(c) *The Power of Directors to Vote Themselves Salaries, Commissions, Fees, Expenses, etc.* Where such power is possessed, unless counteracted by additional voting control of the purchaser in a form such as has been suggested, it would be possible for the other (old)

directors to deprive him of profits, by voting practically all profit away in the form of directors' salaries, etc.

2. Taking Preference Shares.

Where it is proposed to take up preference shares in a limited company, very careful examination of the articles and regulations of the company as to general and voting rights is also necessary. Many companies, both public and private, impose restrictions upon the voting powers of preference shareholders, and thus it should be seen that one's client is not unduly penalized in that direction, without having corresponding advantages conferred upon him. The advantages which could be conferred upon him, should either the company or the shareholders insist upon restricting his voting powers, may include a participating right in the profits apart from his preferential dividend; priority as to the repayment of capital in the event of a liquidation; the right to share in a surplus of liquidation *pari passu* with the ordinary shareholders; and the right to receive and inspect balance sheets.

3. Taking up Debentures in a Company.

Where the investment comes under this heading, it is advisable to ascertain whether the debentures are to be naked or whether they are to confer a fixed or a floating charge on the assets. It should be borne in mind that even if debentures give a floating charge over the whole of the assets there is nothing to prevent the company from subsequently issuing further debentures giving a prior charge on certain fixed assets, and thus materially lessening the security afforded in the earlier issue. Such a contingency may be covered by a special clause in the debenture.

It is necessary that debentures be registered both in the company's own books and in that kept by the Registrar of Companies, and that though failure to register in the company's own register of charges imposes merely a penalty upon the company, and upon every director and officer concerned, failure to register with the Registrar of Companies invalidates the charge given by the debenture altogether. For the client's protection it is necessary therefore to see that the company complies with the necessary registration with the Registrar of Companies.

Also it is advisable to see that power is contained in the debenture deed for a receiver to be appointed by the mortgagee by writing under his own hand, as in the absence of express right in the debenture deed there is no implied right to do so, and if at any time he desired to appoint a receiver, it would be necessary to apply to the Court for an appointment, with the corresponding costs and delays.

Although a debenture granting a floating charge usually gives ample security to the debenture holder—provided there is a reasonable margin of security—if the company is insolvent the security is materially lessened because, in certain circumstances, debentures created by an insolvent company are invalidated. Where an insolvent company has issued debentures giving a floating charge within six months next prior to the liquidation, the charge given by the debentures is void, except to the extent of any cash actually advanced at the time of, or subsequent to, and in consideration of, the debenture together with interest thereon at the rate of 5 per cent per annum. It will be observed, of course, that there is perfect protection against a cash advance even in the case of an insolvent company, but care should be taken that the cash

which is advanced under the debenture is not paid into the company's coffers until the debenture has been executed, and that the debenture deed particularly recites that the cash is being paid in consideration of the debenture deed, and as a current, and not as a past, consideration.

4. Making a Loan Other than as Shareholder, Debenture Holder, or Partner.

In circumstances falling within this category the main point for consideration is the security which is to be given by the borrower. The form of security may be one of many which can be acquired. Generally, these may be classified under the following headings—

1. Mortgages on land or buildings.
2. Investments which have a definite Stock Exchange quotation, or at least a ready market for sale.
3. Life policies (which have surrender values).
4. Charges, such as charges on reversions or life interests.
5. Personal guarantees.

Where the security offered is one of the kinds mentioned above, investigation of title of the security should be made, and it should be seen that such is properly made over for the consideration which is being advanced.

Where money is proposed to be lent on security of a mortgage the advice of a solicitor and of a valuer is essential. There are, however, some points which the investigating accountant should bear in mind from the point of view of the layman as contrasted with that of the solicitor. He should see (*a*) that the money is being lent on first mortgage and not second mortgage; (*b*) that the property is freehold property, or if leasehold, that it has a long tenure; and (*c*) that

there are no restrictive covenants of an unreasonable nature in the lease.

Sometimes it happens that an investor is only prepared to advance money in return for a comparatively high rate of interest. Where this is so, it is necessary to have the loan fixed for a definite number of years so that the mortgagor cannot, when he chooses, effect a redemption. Protection for a specified term should be secured in the deed. On the other hand, where the rate of interest is the normal market rate it is generally desirable to have inserted in the deed the usual terms of repayment on notice so that if the lender desires at any time to invest the money to a better advantage he can do so by calling in the mortgage.

When taking security in the form of investments, being inscribed stocks, registered stocks, or bearer bonds, an investigator should see that the inscribed stocks are actually transferred to the lender's name in the books of the bank of inscription; that the registered stocks are actually transferred to him; or in the case of bearer bonds, that they are actually handed over with all coupons for future dividends and interest intact.

Where the security offered is a life policy, it should be seen that it is definitely assigned to the lender, that all the premiums up to the date of making the loan have been paid, and that the surrender value of the policy fully covers the amount proposed to be advanced. In addition, as it may become necessary for the lender to pay further renewal premiums on the policies in order to keep them alive, if he has an insufficient margin of security because he has lent a sum practically equal to the surrender value, it follows that when he is called upon to pay the renewal

premiums he will then have advanced more than the value of the security. This must, therefore, be taken into consideration in fixing the amount of the loan.

If by way of security for a loan it is proposed to take a charge over a reversion or life interest, the charge deed should be prepared by a solicitor on behalf of the lender, as it is very desirable to make certain that there is no restraint on anticipation clause in respect of the life interest or reversion. A restraint on anticipation is a clause inserted in the deed creating a settlement whereby the settlor makes it impossible for beneficiaries to charge in any way the moneys to which they may be entitled from time to time in the future, and where there is such a restraint on anticipation clause in the settlement any charge granted in contravention thereof would be void against the claimants. The solicitor should investigate the full details of the settlement which it is proposed to charge and should see that the charge is properly drawn up, executed, and stamped.

In the case of a guarantee, the guarantee cannot be given by the actual borrowers. The essential of a guarantee is that it be given by a third party as distinct from the original debtor and creditor.

This type of security is probably the most difficult for the investigating accountant satisfactorily to handle. The inquiry concerns largely the personal stability of the guarantor or guarantors. Tact and discretion are needed, and should be used to the full in ascertaining information relating to the position (both business and private) of the guarantors, such as the following :

(a) The nature and condition of their businesses. (Are they profitable, are they heavily mortgaged, etc.?)

(b) The normal state of their bank balances.

(c) Their business connections and standing generally. (Much of the foregoing can be obtained through trade inquiry societies.)

(d) How do they get their living, if not in business?

(e) What private investments have they?

(f) What sort of property have they? (In the event of its becoming necessary to call them as guarantors.)

(g) Are their private properties (such as private investments or house property) in their own or their wives' names?

(h) Is their furniture their own or subject to a valid ante-nuptial marriage settlement?

(i) Have they entered into obligations besides those which they now propose to enter into?

(With regard to this last point, probably the only way possible to ascertain the information is by making personal inquiries direct from the guarantor, asking, if necessary, to see his private banking account, and if thought necessary, by making him give information on oath by means of a statutory declaration.)

Charging of Assets.

In many cases, especially where the person on whose behalf an investigation is being made proposes to lend money or to leave for a further period loans previously made, quite in addition to other inquiries, it is always advisable to try to ascertain whether the assets of the debtor, or any of them, are already charged. Where the debtor is a company, details of the charges may be obtained from the register kept by the Registrar of Companies, especially as regards mortgages created. One cannot always find details on the register concerning the assets of the company, to which they have been mortgaged or where they are held in equitable charge by the bank. In such circumstances

it may be desirable to get into touch with the company's bankers and ascertain from them the position of the assets of the company so far as they are concerned—whether there is any equitable or legal lien on any of the assets of the company in respect of loans, overdrafts, or discounts made to the company.

In the case of a private individual it is more difficult to trace the way in which assets are charged. Recourse may, however, be had to Land Charges Registers kept by local authorities, in which all charges on land must, to be valid against persons acquiring an interest in such land or buildings, be registered. These registers are available for public inspection.

The Register of Bills of Sale should also be searched.

With regard to charges on insurance policies, it may be possible to obtain the requisite information from the insurance company. It certainly is so if the insured's authority is obtained, and any refusal to grant the necessary permission might reasonably cause the investigator to regard the policy as already fully charged.

CHAPTER XV

INVESTIGATION ON BEHALF OF A SHAREHOLDER'S COMMITTEE

It sometimes happens that a meeting of shareholders of a company decides to appoint a committee to investigate the company's affairs, and for such committee to seek the assistance of an investigating accountant expert in these matters, in order to enable them to bring to a successful conclusion the duty which has been imposed upon them by their fellow shareholders. In these circumstances the investigator should examine the resolution of the shareholders that he may see the precise terms of the resolution under which the committee is appointed, and having ascertained as much as possible of the general position of the company's affairs, and the causes which have led to the appointment of the committee, he will be in a position to appreciate more fully the object of the investigation. His own mandate comes from the committee, but it is advisable to get it agreed in the light of full knowledge of the circumstances existing prior to the execution of any work.

Scope of the Investigation.

It need hardly be stated that the scope of the investigation will depend to a very large extent on the terms of the resolution under which the committee is appointed, and its requirements so far as the investigation is concerned. Such cases generally extend considerably beyond the accounts, as it is the management of the business that is subject to criticism.

While the accountant will investigate the accounts,

it will probably happen that a large portion of the inquiry into the management will be made by the committee itself. In the accounts and matters affecting them, such as the counting-house arrangements, internal check, costing, and the financial policy, etc., there will be ample material upon which the investigator can exercise his professional skill.

In reporting to the committee that has appointed him, the investigator should state all relevant facts ascertained by him so that the members of the committee may decide what shall be disclosed to the shareholders generally, and what shall be done in the circumstances.

CHAPTER XVI

INVESTIGATION OF TRUST ACCOUNTS

AN accountant may be requested to perform an investigation of the accounts of a trust.

The Public Trustee Act, 1906, provides that an investigation can be obtained whether the Public Trustee is acting in the case or not.

Statutory Provisions.

Section 13 of the Act prescribes as follows—

(1) Subject to rules under this Act, and unless the Court otherwise orders, the conditions and accounts of any trust shall, on an application being made and notice thereof given in the prescribed manner by any trustee or beneficiary, be investigated and audited by such solicitor or public accountant as may be agreed on by the applicant and the trustees, or, in default of agreement, by the Public Trustee or some person appointed by him; provided that (except with the leave of the Court) such an investigation or audit shall not be required within twelve months after any such previous investigation or audit, and that a trustee or beneficiary shall not be appointed under this section to make an investigation or audit.

(2) The person making the investigation or audit (hereinafter called the auditor) shall have a right of access to the books, accounts and vouchers of the trustees, and to any securities and documents of title held by them on account of the trust, and may require from them such information and explanation as may be necessary for the performance of his duties; and upon the completion of the investigation and audit shall forward to the applicant and to every trustee a copy of the accounts, together with a report thereon, and a certificate signed by him to the effect that the accounts exhibit a true view of the state of affairs of the trust, and that he has had the securities of the trust fund investments produced to and verified by him, or (as the case may be) that such accounts are deficient in such respects as may be specified in such certificate.

(3) Every beneficiary under the trust shall, subject to Rules under this Act, be entitled at all reasonable times to

inspect and take copies of the accounts, report, and certificate, and, at his own expense, to be furnished with copies thereof or extracts therefrom.

(4) The auditor may be removed by order of the Court, and if any auditor is removed, or resigns, or dies, or becomes bankrupt, or incapable of acting before the investigation and audit is completed, a new auditor may be appointed in his place in like manner as the original auditor.

(5) The remuneration of the auditor and the other expenses of the investigation and audit shall be such as may be prescribed by rules under this Act, and shall, unless the Public Trustee otherwise directs, be borne by the estate; and in the event of the Public Trustee so directing, he may order that such expenses be borne by the applicant or by the trustee personally, or partly by them and partly by the applicant.

(6) If any person having the custody of any documents to which the auditor has a right of access under this section fails or refuses to allow him to have access thereto, or in any wise obstructs the investigation or audit, the auditor may apply to the Court, and thereupon the Court shall make such order as it thinks just.

(7) Subject to Rules of Court, applications under or for the purposes of this section to the High Court shall be made to a judge of the Chancery Division in Chambers.

(8) If any person in any statement of accounts, report or certificate required for the purpose of this section wilfully makes a statement false in any material particular he shall be liable on conviction on indictment to imprisonment for a term not exceeding two years, and on summary conviction to imprisonment for a term not exceeding six months, with or without hard labour, and in either case to a fine in lieu of or in addition to such imprisonment.

The above provisions have been amplified by the Public Trustee Rules, 1912, as follows—

Rule 31.—Any application under Section 13 of the Act shall be made to the Public Trustee, and notice thereof shall (unless the Public Trustee otherwise directs) be given by the applicant to every other person being a trustee or beneficiary under the trust.

Rule 32.—(1) Upon receiving any such application the Public Trustee may in his absolute discretion by notice to the applicant require that before a day to be specified in the notice such security (by deposit of a sum of money) as he shall deem sufficient shall be given to him by the applicant for the payment of any expenses of the investigation and

audit which may be ordered by the Public Trustee to be paid by the applicant personally.

(2) Where any such requirement is made no further proceedings shall be taken upon the application until the security has been given, and if the same is not given before the day specified in the notice the application shall be disallowed unless under special circumstances the Public Trustee thinks fit to extend the time for giving the security or to dispense therewith.

(3) Any sum so deposited shall be kept by the Public Trustee on deposit in his name and to a separate account at a bank until all proceedings in connection with the investigation and audit have been concluded, and thereupon the deposited sum and the interest (if any) allowed thereon by the bank shall be applied in or towards payment of any expenses of the investigation and audit which may be so ordered to be paid by the applicant personally, and the balance (if any) shall be paid to the applicant.

Rule 33.—The Public Trustee may in his absolute discretion upon the application of any trustee or beneficiary direct that the investigation and audit shall extend only to a specified period of time or to a specified part of the trust property or shall be otherwise restricted.

Rule 34.—If within one month from the date of the application under Section 13 (1) of the Act no solicitor or public accountant shall have been appointed by the applicant and the trustees to conduct the investigation and audit, there shall be deemed to be a default of agreement within the meaning of the said Section 13 (1) and the applicant may apply to the Public Trustee accordingly.

Rule 35.—The remuneration of the auditor and the other expenses of the investigation and audit shall be such as may be determined by the Public Trustee. Provided that the Public Trustee may refer the cost of any solicitor (being part of such expenses) for taxation to a Taxing Master of the Supreme Court, and in such case the amount of the said costs when taxed shall be included in such expenses.

Rule 36.—(1) Where any investigation or audit has been made, copies of the report and certificate of the auditor under Section 13 (2) of the Act and such copies of accounts and other documents as the Public Trustee may require shall be forwarded to him by the auditor, and shall be considered by the Public Trustee before giving any direction or making any order under Section 13 (5) of the Act.

(2) The expenses of making and forwarding any such copies as aforesaid and the fee of the Public Trustee (within the limits prescribed by or in pursuance of any order relating to

the fees of the Public Trustee for the time being in force) shall for the purpose of Section 13 (5) of the Act be part of the expenses of the investigation and audit.

Rule 37.—(1) Before making any order under Section 13 (5) of the Act the Public Trustee shall, if any of the parties interested so desire, hear the said parties in such manner as he shall think fit.

(2) Any such order shall specify the person by or to whom any sum is to be paid and the amount of such sum provided that such an order may direct payment of the taxed costs of any solicitor employed in connection with the investigation and audit, and such cost shall be taxed by a Taxing Master of the Supreme Court, and the amount of such costs when taxed shall be paid as if such amount had been specified in the order.

(3) Any such order may be enforced in the same manner as a judgment or order of the Court to the same effect.

From the foregoing it will be observed that the investigation may be put in the hands of a solicitor or a public accountant to perform. On appointment, the investigator is entitled to have access to the books, accounts and vouchers of the trustees, and to any securities and documents of title held by them on account of the trust, and he may require such information and explanation as may be deemed necessary for the performance of the task. Though he has a right to inspect all books and documents, the trustee is entitled to make terms with him before producing them; and if the trustee refuses to produce them he should apply by originating summons to the Chancery Division for an order for their production. Investigation will be the easier if accounts have been kept, but where they have not, the investigator must prepare accounts, as he is required to forward a copy of them to the person applying for the audit, and to every trustee.

The Line of Action.

Amongst the first documents to be inspected after obtaining the accounts (if any) will be the Will or

the Trust Instrument, the terms of which must be thoroughly grasped, taking particular note of legacies, devises, specific trusts, investments authorized, carrying on business, payment of unenforceable debts, treatment of annuities, and the allocation of specific property for discharge of debts.

Where the case concerns the estate of a deceased person the private books and records should be obtained to ensure that all assets have been brought into account. These should all appear in the Estate Duty Account, of which a copy should be asked for. This document should show all property and liabilities and the funeral expenses and the duty payable together with interest thereon.

The Estate Duty Account should be debited with all liabilities (separate accounts being opened for each), and it should be credited with all assets which also will be recorded in separate ledger accounts.

The cash book presents no really outstanding features. The following are the main items which differ from that of a trading concern—

Receipts side—

Sales of investments	Stockbrokers' notes.
Dividends, etc.	Statement portions of warrant.
Rents	Counterfoil receipt book and/or rent rolls, agents' returns, etc.
Sales of properties	Auctioneers' accounts, solicitors' letters, etc.
Debts (receivable)	Copy letter book and/or such other evidence as is available from books kept, etc.

Verify with—

Payments side—

Estate duty	Probate of the will.
Legacies	Receipts properly stamped.
Purchase of securities	Stockbrokers' notes, etc.
Annuities	Receipts.
Miscellaneous	Receipts.

In the case of legacies not left free of duty it should be seen that they are paid net, and that the duty is accounted for to the Revenue.

It should be seen that executorship expenses are proper and reasonable, and it must be remembered that neither an executor nor a trustee is entitled to charge for his services unless the will or trust deed specifically authorizes him to do so.

Apportionments.

These should be carefully scrutinized in order that accuracy may be attained between capital and income and that all parties are properly treated according to law and the authorising deed, e.g. between life tenants and remaindermen. In addition, a correct apportionment is necessary to ascertain the amount of estate duty rightly payable and to determine the incidence of charges and expenses.

In dealing with apportionments the provisions of the Apportionment Act, 1870, must be worked to. In addition, a good knowledge of case law is necessary. The important cases are set out and fully explained in all good textbooks on Executorship and Trustee Accounts.

A detailed consideration of all relevant cases is not reasonably practicable in the present treatise, partly in consequence of the space which would be required, and largely because no accountant is likely to undertake an administration or an investigation of a complicated executorship or trust without making or having already made a careful study of the subject. The important cases range over the last 130 years from the rule established in *Howe v. Lord Dartmouth* in 1802, up to the present date.

Even then, it is advisable in certain cases to get

Counsel's opinion or, perhaps, an order of the Court to determine the correct procedure.

Investments should be scrutinized to see that they are either those in which executors and trustees are authorized to invest under the Trustee Acts and amending Statutes, or are authorized by the will or trust deed. Executors and trustees are personally responsible for any devastavit occasioned by their improper conduct, and any such wastage should be reported by the investigator to the person who applied for the investigation and to all trustees. Specific trusts created under the will or trust investment and earmarked investments in respect of them, should be carefully scrutinized.

Investments quoted *cum div.* at the date of death should be brought into the Estate Duty Account at that figure which includes dividends accrued to date in addition to price. The dividend when received will be apportionable in accordance with provisions of the Apportionment Act, but the capital portion, instead of being credited to the Estate Account, must be utilized for the purpose of adjusting the capital value of the asset.

In the verification of assets it is generally desirable that all items be treated, involving an inspection of title deeds, share certificates, letters of verification relating to inscribed stock, and in the case of investments registered in the name of a sole executor or trustee his certificate that he holds the same on behalf of the estate or trust free from encumbrances.

Under the Public Trustee Act, under which the investigator is required to conduct the inquiry, he is required to certify that he has had the securities of the trust fund investments produced to him and that he has verified them or otherwise.

Where the Business is Carried On.

Where the business of a deceased person is being carried on by his executors, or trustees, either in accordance with the instructions in the will, or for the purpose of being wound up, accounts ought to have been taken at the date of death to ascertain the exact position of the business, and these should be examined by the investigator. It is generally considered necessary to audit the accounts of the business since the date of death.

Except for the purpose of beneficially winding up the business there is no power to carry on a business unless express directions are given by the will. Thus, in the absence of a distinct and positive authority to this effect, the executor is personally responsible for debts incurred, with no right to be reimbursed out of the estate. If there be an authority to carry on the business he is still liable for debts incurred, but is entitled to be indemnified out of the specific assets which he is authorized to employ.

It should be remembered, however, that though the will gives no authority to carry on the business, the executor is entitled to indemnity if the beneficiaries or even the creditors of the deceased were aware of the fact and tacitly assented to it.

On completion of the investigation, the accountant must forward to the applicant and to every trustee, a copy of the accounts, together with his report thereon, and certificate of correctness or otherwise.

The certificate will be in the following form—

I hereby certify that the above accounts exhibit a true and correct view of the state of the affairs of the.....Trust, and that I have had the securities of the Trust Fund Investments produced to me, and that I have verified the same.

or he will modify it with particulars of any matters

in respect of which the accounts are incorrect or the production of securities is deficient, or will refer to the report in which these matters are stated.

Liability of Investigators.

Before leaving the consideration of this type of investigation it is well to indicate the liability under which an investigator stands in the event of his being negligent in his work.

Liability exists to those persons under whose mandate the investigator has acted, and is in the form of a liability arising out of contract, the only person who is able to sue being the other party to the contract.

It is of course impossible here to set out exactly what constitutes negligence. It depends upon the particular circumstances of the case under review. It is a question of fact, and where litigation results, the determination of facts is ascertained by reviewing what has been done, and by calling expert evidence by both sides to the action to prove what independent experienced persons consider should have been done, having regard to their experience in similar matters.

Though liability for negligence in the exercise of the skill which ought reasonably to have been accorded lies only to the other contracting party, there may be liability to third parties in cases where the investigator has deliberately misrepresented matters with the intention that the misrepresentation should be acted upon by the third party. Such would involve an action for tort, and fraud would have to be proved if the appellant is to be successful in the action.

While in all investigations it is advisable for the investigating accountant to keep full notes of the information received and of his action and procedure in the matter so that, if necessary, he can at any time

substantiate any statement made, it is especially desirable that great care be exercised in this respect in connection with investigations into trust accounts in view of his liability under the contract for care, skill, and caution, and the possibility of further liability in the event of an action for tort.

CHAPTER XVII

INVESTIGATIONS INTO THE AFFAIRS OF DEBTOR WHERE CREDITOR DESIRES TO MAKE DECISION CONCERNING DEBTS

INQUIRIES of this nature arise at the request of a creditor, who may be a trade creditor, a banker who has allowed an overdraft, or other person who has advanced money or its equivalent and who has not met with success in his requests for a prompt discharge.

Bankruptcy or Liquidation.

The creditor's question is—what is the best step to take? He wonders whether to defer stronger action for the present in the hope that he will be paid sometime, or whether time will not ameliorate the situation but probably make his chances of recovery less strong. Would it be best to sue for payment or to enter into a legally binding arrangement for liquidation of the amount by definite instalments on special terms, or would it be better to put the debtor in the Bankruptcy Court, or if a company, cause it to go into liquidation?

Proper consideration can be given only on knowing the exact circumstances of the case.

In addition to the technical inquiry by the investigating accountant into accounts, reports of trade societies, etc., his judgment and discretion if well balanced and backed by wide experience, his ability to judge men and their ways, and to form a reliable opinion on the trend of events in general and of those relating to this debtor in particular, need to be brought into action if he is to be of the utmost service to the

creditor who has enlisted his services. If it is reasonably obvious that the debtor can continue to carry on business and make a profit it may, if other conditions are favourable, be advisable to wait a while before taking any action beyond keeping a close watch and demand on him. This may be effected by making an arrangement whereby the debtor will be allowed to continue his business, making gradual payments towards liquidation of his liability. An inspectorship deed is of course desirable. In reverse circumstances, where there appears to be no likelihood of a profit being made in the near future, it will probably be best to advise the creditor to cut his loss by putting the debtor into bankruptcy or liquidation at once, because the longer the delay the less is he likely to get.

Inspectorship Deed.

For the benefit of the less experienced reader a brief explanation of an inspectorship deed (which really amounts to an act of bankruptcy) may be helpful.

It is a deed entered into between a debtor and his creditor whereby the debtor is allowed to carry on his business under the supervision of one or more inspectors appointed by the creditor, subject to his paying the net proceeds of trading from time to time into a banking account opened by the inspectors and to the making of the necessary payments thereout.

An alternative method to an inspectorship deed is by a deed of assignment. It is perhaps unfortunate that deeds of assignment have become notorious as almost necessary precedents to bankruptcy proceedings, and the very fact of a debtor having executed a deed of assignment makes it more difficult for him to continue his business than if he has executed an inspectorship deed.

In the case of a limited liability company an inspectorship deed or a deed of assignment is not possible, but the Companies Act has made a very admirable provision for arrangements of a similar type to be carried into effect. It is enacted that where it is proposed that a company should enter into a compromise or an arrangement with its creditors or shareholders, or any class of them, any persons interested in the scheme may apply to the Court to direct that a meeting of the creditors or shareholders, or any class of them be called, and if at that meeting the motion is accepted by a majority in number equivalent to three-fourths in value of all shareholders or creditors of that class, then any person interested can apply to the Court a second time for the scheme to be confirmed, and the Court, if satisfied that it is just and equitable, and in the best interest of the company itself and the shareholders and/or creditors, it will confirm the scheme, and it will then be binding upon the company and upon all the shareholders and/or creditors, even on those who may have voted against the scheme, and upon any subsequent liquidator of the company. These provisions can always be put into operation either whilst the company is still in business or even while in liquidation. A scheme provides for the business to be carried on under the auspices of one or more inspectors appointed by the creditors as a body.

CHAPTER XVIII

INVESTIGATION ON BEHALF OF PERSON PROPOSING TO SUPPLY GOODS ON TERMS OF EXTENDED CREDIT

SOME points for inquiry by an investigator in cases where it is proposed to allow extended credit to new customers, or those who have not previously been supplied, or those who have not previously been supplied on such terms, are as follow—

1. The maximum amount which may be outstanding at any time.

2. The probability and possibility that the debtor will duly meet his liabilities by the appointed date, such as—

(a) The stock held by him from time to time ;

(b) The terms on which he sells.

3. The arrangements made for the eventual liquidation of the debt.

Under point (3) fall for consideration circumstances such as the *permanent* indebtedness of a large amount—probably the full extent of the credit. As an illustration of what is meant, extended credit may be granted for a considerable sum, and for years all payments as agreed may be duly made, but after years there is still the same total indebtedness. The debtor has regarded the extended credit not as a temporary aid but as a permanent loan or capitalization of his business. Thus, the investigator should bear in mind that a state of affairs of this nature may arise in the case he has under review unless provision is made to the contrary.

There are ways of overcoming this, of which the following are probably the chief—

(a) By gradually reducing the amount of credit ;

(*b*) By making it a condition that the purchaser create a sinking fund, or a reserve fund specially earmarked;

(*c*) By the debtor taking out an endowment insurance policy;

(*d*) By insisting that he reduce his outstanding debt by periodical payments to the grantor of the credit.

CHAPTER XIX

INVESTIGATION INTO ACCOUNTS FOR INCOME-TAX PURPOSES

INVESTIGATIONS of the books and records of persons, partnerships, and other types of firm or company for the purpose of settling income-tax matters frequently arise. The circumstances leading to such an investigation are numerous and cover cases such as—

1. Where proper books have not been kept, and where in consequence of not regarding the taxpayer's returns as correct, the Revenue Authorities have made (or threaten to make) an assessment or assessments on figures estimated (or guessed at) by themselves.

2. Where books have been kept, but the authorities are not satisfied with the taxpayer's returns and either unsuccessfully request production of the books or having inspected them find that a greater profit than that disclosed appears to have been made, and in order either to force production of the books or duly certified accounts an assessment intentionally excessive is made.

3. Where under-assessment has been made in consequence of innocent misstatement of facts, or where there has been deliberate avoidance of tax by making fraudulent statements.

4. Where a taxpayer spontaneously requests an investigation into his affairs with a view to knowing his position so that he may—

(a) Make a voluntary disclosure of any under-statements and so avoid proceedings by effecting an amicable settlement; or—

(b) Reclaim tax where, owing to errors in books

and/or ignorance of his rights he has paid more tax than he was liable for.

5. Investigations made at the request of the Revenue Authorities.

It will at once be realized that the line of action by the investigator will depend on his instruction and on the circumstances of the case; and so no hard-and-fast procedure can be set out that would be applicable to all or even to many cases.

A thorough knowledge of income-tax law as well as of accountancy should be possessed by every accountant undertaking an investigation for income-tax purposes.

Merely as a general indication of the kind of action to be taken the following points are named. The investigator should ascertain—

(i) That proper allowances are claimed under all headings under which the taxpayer is entitled;

(ii) That all exempt income is eliminated from the accounts;

(iii) That all taxable income, even though extraordinary, is brought into account;

(iv) That every legitimate item of expense is deducted from profit;

(v) That items of a doubtful nature are eliminated, shown separately, and fought in the taxpayer's favour;

(vi) That notices of objection are given within the prescribed period and properly fought before the Commissioners;

(vii) That tax overpaid be reclaimed where possible;

(viii) That penalties are properly explained to the taxpayer.

CHAPTER XX

REPORTS ON INVESTIGATIONS

AN investigating accountant's report should aim at exhibiting in the smallest possible compass all the important points covered by the investigation. Masses of detail should be avoided in the body of the report. Nevertheless, both for the sake of completeness of information and incidentally for reasonable protection of the investigating accountant, the scope of the investigation should be clearly indicated, together with particulars of the means adopted and the limits of the inquiry.

Style in the Report.

The report should be lucid and complete without prolixity. It should contain references to all salient points. It should be properly divided into sections under appropriate and well-chosen headings and sub-headings. In order to keep the report within reasonable limits and incidentally to present it so that one may understand its import with the minimum of trouble and time, details may, where possible, be recorded on schedules to which the figures and other matters in the body of the report are fully referenced. Each subject dealt with in the report should be in its proper logical sequence and, needless to state, the schedules should also be correctly arranged.

Terminology used should be explicit, avoiding all ambiguities and alternate (doubtful) names for things previously referred to in other language. Every effort should be used to present the matter in the best literary style, but such a desire ought not to be allowed to interfere in the least degree with accuracy of import,

nor may a fear of tautology or redundancy be allowed to creep in, if its avoidance would involve any risk of misinterpretation.

Essentials in the Report.

While the main essentials to be borne in mind in preparing a report on an investigation are accuracy of fact, clarity of meaning, and reasonable conciseness, there are other factors which, if incorporated, add all-round value and interest to it.

Literary skill, though of only secondary importance to an accountant, is a valuable and useful possession.

It is not sufficient to have *acquired* a full knowledge of the case investigated—that information has to be transmitted to paper. In presenting facts, aim should be made to attract and retain the attention of all readers of them. This is most easily attainable by using pleasing language and by infusing interest in the subject. A manner of expression should be adopted that will exhibit—

1. Extreme clearness of meaning;
2. The right application of words and expressions;
3. The absence of redundancy, tautology, and superfluity; and
4. The correct classification of matter.

In writing the report the treatment of the subject-matter must be systematic and intellectual. The matter must be thought out. Some suggestions as to the method of dealing with these points are—

1. Incorporate references.
2. Review the circumstances of the case.
3. State the arguments for and against and contrast the merits and demerits, where appropriate.
4. Draw conclusions from such contrast, supporting them with statistics, precedents, parallel cases,

and independent authoritative opinions where appropriate.

5. Make comparisons, but see that they are analogous.

6. State all essentials, but carefully avoid all non-essentials.

7. Where a matter can be viewed from opposite standpoints, state both sides of the question and, if possible, attempt to reconcile them.

8. Avoid all party or political bias.

9. Be constructive as well as destructive, i.e. if a system, etc., be criticized suggest an alternative method.

10. Do not be dogmatic.

11. Avoid, where possible, the first person and accusative, apologetic and laudatory compositions.

12. If the report is lengthy a brief summary of the main points is useful at the end.

13. Never fail to distinguish between fact and opinion.

Preservation of Notes.

In order to be able to substantiate any statement or reports made, or certificates given, an investigating accountant should keep and preserve full notes of all explanations received and all work done. It may be necessary sometime in the near or distant future for the investigator to substantiate something done, and if a considerable period has elapsed since its happening, time and other matter may have impaired his mental recollection of the events in question. Or it may be that information is wanted at a time when he who did the investigation is no longer available for the purpose of supplying it, and so the records should be so kept that a successor will be able to furnish the required information.

CHAPTER XXI

A MATTER OF ETHICS

To what extent (if any) is a professional accountant justified in using bluff and in laying traps with a view to trapping suspected individuals and obtaining information from "innocents" by means more or less subtle? This is a question to which there may be different replies.

A few matters illustrative of what is in the author's mind are given in the hope that the idea may be used by those who do not disapprove of the method in the discovery of something which might not otherwise be brought to light.

At the outset, the writer would make it perfectly clear that he very strongly discounts the idea of faulty organization and of deliberately laying traps to cause the downfall of anyone, who, it is thought, would otherwise go straight.

The organization should aim at making fraud and losses through carelessness or indifference impossible.

Dishonest Cash Collectors.

Should high denomination coins (e.g. florins) be put in automatic machines, locks, etc., to see whether the collectors will pay in such coins or substitute coppers therefor? Where a person is definitely under suspicion one is inclined to say "yes," even if the action be not recommended as a regular feature.

A Question of Rent.

If there is a doubt as to whether a tenant has actually paid his rent and that the collector is temporarily (or otherwise) retaining the proceeds for his own use, or

A shrewd accountant possessed of the personal qualifications advocated earlier in this book, should be able to form an accurate opinion of the character of the individual whose records have to be inspected. It is at this juncture that the investigator may consider whether or not he intends to try to outwit him. If he decides to adopt such a course he may, by actions, by carefully chosen words, and by his general manner, cause an impression to be drawn that his efforts will be of a formal kind only, though he may express his desire to see all the books and papers, inferring that he will have to report that he has done so.

By this means an investigating accountant may obtain all desired information without any opposition, in fact, with every possible assistance.

Making Opportunity for Bribes.

Genuineness of statements and motives have been tested by an accountant tactfully pretending by inference that slight tokens in the form of something fancied would not be refused, e.g. reference could be made to something presented by a person whose books were once being inspected. If the bait is taken and a bribe offered, the type of individual has been disclosed, and the value of the offer is in some measure an indication of his depth.

CHAPTER XXII

INTERNAL INVESTIGATION DEPARTMENT

JUST as many large firms and public bodies have established an internal audit department, so might they with advantage create a corresponding section to deal with investigations. Alternatively, the internal audit and investigation branches might economically be one department, provided, of course, the head and his assistants are in all ways qualified to perform the dual office.

Internal Audit and Investigation Department Combined.

The institution of an investigation office, either separately or as part of the internal audit department, would not preclude the engagement of outside experts if and when any special occasion arose. But such external contracts would be rare, partly because of the infrequency of the special matters, and largely in consequence of the employment of a highly-skilled head of the department. This arrangement actually operates in some of the larger concerns.

All the types of investigation named in this book may be undertaken by such a section of one's organization.

Special Utility to Local Authorities.

In addition to most, if not all, of the types of investigation already treated which are equally applicable to local authorities, there are a great many matters

which call for investigation rather than audit. Matters which ordinarily fail to receive any measure of inquiry or scrutiny beyond what the persons responsible for the duties themselves perform.

By way of illustration, a variety of matters which could conveniently fall to be scrutinized by a local authority's own investigation staff (those which would otherwise fail to receive the attention they merit) are given below—

Stock shortages.

Cost statements and ledgers ;

Statistics generally ;

Depreciation provision ;

Reserves and reserve funds ;

Capital and revenue expenditure ;

Loans and borrowing powers, matters ;

That rate limits (if any) are not exceeded ;

That expenditure is not *ultra vires* (i.e. outside the powers of the local authority) ;

That statutory requirements are complied with in so far as relates to the fact that certain expenditure can only legally be defrayed out of certain funds ;

That due and proper provision is made for the redemption of debt ;

That no income is lost or unaccounted for, including loss of interest through delay in claiming Government grants, income-tax repayments, etc ;

That proper Government sanctions are in hand before loans are raised for a specific purpose ;

That loan moneys are not allocated to works in excess of the amounts sanctioned ;

That full grants and subsidies are received from the Government and without delay ;

That no income tax is paid without liability therefor, including reclaims of tax on income exempted ;

That there has been a proper apportionment of central establishment charges.

Reference to local Acts and Orders to see whether profits of trading concerns transferred in aid of rates are—

- (a) Within the powers of the local authority ;
- (b) Not done before prior charges have been met ;
- (c) Not in excess of the limitation (if any) fixed by the governing statute ;

That no loss in interest is effected by borrowing more money than is either immediately or ultimately required ;

That no money is lost by lack of care in making investments on the best possible terms ;

That no money is lost by borrowing uneconomically ;

Check the establishment, adequacy and legality of reserve funds.

Dozens of other points arise in practice in both commercial and municipal undertakings which could advantageously be referred to an investigation staff.

CHAPTER XXIII

MISCELLANEOUS POINTS.

As the heading of this chapter indicates, the observations made in it are of a general character. Though disjointed points, it is hoped they may be helpful to those who read them.

Outside Information.

In seeking information concerning debtors, firms, assets, etc., all available sources should, where appropriate and necessary, be used.

These include—

1. The Register of the Registrar of Companies.
2. The Register of Business Names.
3. Credit Agencies and Business Inquiry Societies.
4. Land Charges Registers.
5. The Register of Bills of Sale kept by the Registrar of Bills of Sale.
6. Bankers.
7. Accountants.
8. Solicitors.
9. Insurance Companies.

From the sources named in (1) and (2) above, it is possible to ascertain the names, addresses, and descriptions of all persons engaged in the business, as partners, directors, shareholders, or debenture-holders; also the time when the business started, or when the company was formed; any changes which may have been made from time to time in the partnership or directorate thereof; and in the case of a public company, further information from copies of prospectuses, and filed

balance-sheets in respect of every year since the company became entitled to commence business.

Through Credit Agencies and Inquiry Societies, under whatever name they carry on, of which there are many, one may be able to get information showing the general opinion in commercial circles of the business which one is investigating—its credit, the way in which it has met its obligations in the past, and the general opinion held by firms with which it has been trading.

Bound Books and Loose-leaf Ones.

Bound books can no more be regarded as safe than can loose-leaf ones. One of the biggest frauds of recent years was perpetrated with bound books.

Prevalence of Wrongful Handling of Monies.

“Teeming and lading,” as it is commonly called, is indulged in to a greater extent than one is perhaps inclined to imagine, until inquiry is made.

Accurate Accounts may Need Adjusting.

It does not follow that if it be known as a certainty that the books, records, and even policy of a business firm are absolutely beyond reproach a careful scrutiny is not necessary, and that an adjustment will not have to be made in the ordinarily perfect accounts for the purposes for which the investigation is being carried out.

Dangers of Ultra Prudent Policies.

An ultra prudent financial policy may, in fact, certainly does lead, to an over-statement rather than an under-statement of profits in later periods. For example, if excessive depreciation be written off plant in early years the book value is too low and, thus, the annual

depreciation calculated thereon is less than the year's real depreciation, and profits are, in consequence, inflated. Especially does this apply where a system of defraying capital expenditure out of revenue account, or "pay-as-we-go" policy, has been in operation.

Miscellaneous Profits.

Income from sales of capital assets, and also the expense of such sales, should be eliminated from profit.

Sales of patents or copyrights may not only produce large capital or non-recurring profits, but may render costly and specialized plant, or a distributing organization, comparatively useless.

Profits and losses on foreign exchange conversions need careful consideration. These may not recur if the currency becomes stabilized.

Goodwill.

Goodwill arises—

- (1) By the personal reputation of the proprietors.
- (2) By the real intrinsic value of the commodity manufactured.
- (3) By the situation of the business.
- (4) By advertising.

The worth of goodwill is the capital value of an annuity of super-profits. Taking the current gilt-edged investment yield as 5 per cent, a base-line for the ascertainment of super-profits is, say, 6 or 7 per cent.

Thus assuming the following figures—

	£
Net value of tangible assets used	100,000
Net actual average profits per annum	12,000
Base-line (say 7 per cent)	7,000
Super-profits	5,000

Capital value of goodwill is £5,000 multiplied by the agreed number of years' purchase.

Miscellaneous Points.

The following are some of the matters to be specially borne in mind when making an investigation generally—

Over-valuing or under-valuing of stock.

Forward dated invoices (involving goods in stock but no creditors in books).

Purchase of goods at convenience of seller involving back-dated invoices, i.e. invoices (creditors) in the books but not goods.

Duplication of share certificates.

Sales of scrap materials.

Writing off without authority.

Excessive or too little depreciation.

Genuineness (or otherwise) of signatures on vouchers.

Defalcations.

“Dummy” workmen.

Capital profits.

Patents, and copyrights.

Profits arising from fluctuations in foreign exchanges.

Special Points not to be Overlooked.

The fee which the client fixes or expects to pay.

The points which are to be reported upon.

Whether the books of the business have been properly written up, balanced and audited, in the past.

The especial characteristics of the trade for example, a wholesale fish merchant's stock is practically cleared daily; while that of a wholesale grocer, carrying a wide range of products, is in a different category; and that of a jeweller even more slow-moving.

The personal nature of the business, and the practicability of the effective transfer of the goodwill as distinct from the nominal or legal conveyance.

The economic and political position of the trade or industry.

INDEX

- ACQUISITION of an undertaking, 2, 16-18
- of land and buildings, 3, 36-40, 94-101
- of Land (Assessment of Compensation) Act, 1919, 95
- of shares or debentures, 2
- Adjustment of profit and loss account, 52-55, 155
- Advertising, 54, 156
- Amalgamation with a business, 2, 19-33
- Annuities, 132
- Apportionments under Apportionment Act, 1870, 133, 134
- Arbitration, 95, 96
- Assets, charging of, 124, 125
- Assignment, deed of, 139, 140
- Attributes of an investigating accountant, 7, 8

- BAD debts, 53
- Balance-sheets, 14, 17, 18, 25, 26, 51
- Balfour, Jabez, fraud by, 89-91
- Bank, fraud by, 68, 69
- , frauds on, 75, 76
- pass-book, 59
- Bankruptcy of debtor, 138-140
- Banks, 14
- Belgrave Cotton Mills' case, 72, 73
- Bills receivable, 71
- , Treasury, 71
- Bluff used by investigating accountant, 57
- Board of Trade, 79-81
- Book debts, 25, 26
- Bound books *v.* loose-leaf books, 155
- Bribes, 150
- Buildings, compulsory acquisition of, 94-101
- Business, carrying on by trustees, 135, 136
- inquiry societies, 154, 155

- CAPITAL expenditure, 53, 152, 156
- Capital profits, 157
- Cash book, 59, 60
- collectors, dishonest, 148
- Centralization of work, observations on, 44-48
- Certificate of investigating accountant, 27, 28, 52, 54, 55
- Character, 7, 12-15
- Chief financial officers of local authorities, 101
- City Equitable Assurance Co. case, 69-71
- Commission, 23
- Companies Act, 1929, 80-93, 116, 117, 140
- in liquidation, frauds in connection with, 79-93
- Comparison of figures, 51
- Compensation for loss of profits, 2, 36-40, 94-101
- Consignments, 23
- Contracts, 3, 84, 85, 102-114
- Copyrights, 156, 157
- Cost contracts, investigation of, 102-114
- statements, 152
- Costing system, 36
- County councils, 94
- Credit and extended credit, 141, 142
- Creditor's decision *re* debts, 138-140
- Cunning outwitted, 149, 150

- DAMAGE to business, compensation for, 99-101
- Dartmouth, Earl of, *v.* Howe, case, 1802, 133, 134
- Debentures, loan by, investigation before making, 119-121
- Debtor's liabilities, investigation of, 3, 60, 138-140
- Deed, inspectorship, 139, 140
- of assignment, 139, 140
- Defalcations, 3, 17, 18, 53, 56-93, 155, 157

Defence of the Realm (Acquisition of Land) Act, 1916, 95
 Definition of "investigation," 1, 2

Depreciation, 25-27, 152, 157
 Devises, 132
 Diplomacy, 9
 Director of Public Prosecutions, 92
 Directors, frauds by, 66-69
 Discounts, 23, 27, 52
 Dishonesty, 148
 Distributing organization, 156
 Dividends, 133
 "Dummy" employees, 60, 157

EMBEZZLEMENTS, 58, 59
 Employees, frauds by, 66, 67
 Employer, frauds by, 67
 Empties, 23
 Endowment insurance policy, 142
 Estate duty account, 132, 134
 Ethics, 148-150
 Executorship accounts, 133
 Extended credit, 141, 142
 Extent of investigation, 3-6, 34, 35, 41-48

FALSIFICATION, methods of, 17, 18
 Falsified balance sheets, 17, 18
 — revenue accounts, 18
 Farrow's Bank case, 68, 69
 Fee for investigation, 157
 Financial position of a concern, 34-40
 — stability, investigation as to, 3
 Fittings and fixtures, 98
 Fluctuation price contracts, investigation of, 102-114
 Foreign exchange, profits, 156, 157
 Fraud, investigation as to, 3, 17, 18, 53, 56-93, 155, 157
 —, types of, 64, 66, 155

GASWORKS, 16
 Goodwill, 18, 31, 32, 36-40, 156
 Government sanctions, 152
 Guarantees, personal, loans on, 121, 123, 124

HATRY, Clarence, fraud case, 65, 66, 76, 89
 Housing of the Working Classes Act, 1890, 95
 Howe v. Earl of Dartmouth case, 133
 Humour, 7, 11

IMAGINATION, 78
 Imprisonment of auditors and defrauders, 69
 Income tax, 21, 28, 42, 101, 143, 144, 152
 Inconstancy of prices, 102, 103
 Inquiry societies, 154, 155
 Inspectorship deeds, 139, 140
 Insurance companies, 14, 154
 — premiums, 52
 Integrity, 12, 13
 Interest, 52
 Internal investigation department, 151-153
 Inventions, 26
 Investigation department, internal, 151-153
 Investments, 53, 132
 —, investigation before making, 115-125
 Investors, investigations on behalf of, 115-125
 Irregularities, 3, 17, 18, 53, 56-93, 155, 157

KINDS of investigation, 2, 3
 Kingston Cotton Mills' case, 63, 72, 73, 88, 89
 Knowledge of men and their ways, 8

LAND charges, register of, 125, 154
 —, compulsory acquisition of, 94-96
 Law costs, 53
 Leasehold interest in property, 98
 Legacies, 132
 Liabilities to be taken over, 29, 30
 Liability of investigating accountants, 136, 137
 Life assurance policies as security, 121-123

Limits of an investigation, 5, 6
 Liquidation cases, fraud in, 79-93
 — of companies, 79-93, 119, 138-140
 Literary ability, 7, 11, 12
 Liverpool Globe Finance Corporation case, 74
 Loans, investigation before making, 115-125
 Local authorities, 94-101, 151-153
 — Government Act, 1888, 94,
 — service, 57, 65
 Loose-leaf ledgers *v.* bound books, 155
 Lord Advocate, 92
 Losses, 52, 53
 Loss of profits, compensation for, 2, 36-40, 99-101

MATERIALS, fluctuations in price of, 108-110
 Matters to be investigated, 20, 21
 Meaning of "investigation," 1, 2
 Mechanical, avoid becoming, 78
 — devices in office, warnings as to recommendation of, 44, 45
 Methods of investigation, 41-48
 Millwall Dock case, 72, 73
 Minute books, 85, 86
 Misappropriations, 3, 17, 18, 53, 56-93, 155, 157
 Mortgage, loan on, 121, 122
 Municipal corporations, 94
 — — — Act, 1882, 94

NATIONAL war bonds, 71
 Negligence, liability of investigator for, 136, 137
 Notes, preservation of, 147

OBJECTS of investigations, 2, 3
 Official Receiver, 80
 "Old and trusted servants," frauds by, 63, 64
 Overhead charges, 21
 Overlapping, avoidance of, 21, 22
 Owner of a business, fraud by, 66, 67

PARISH councils, 94
 — meetings, 95
 Partner, ingoing, special points relating to, 30-33
 Patents, 26, 156, 157
 Patience, 7, 9, 10
 Paying-in book (bank), 59
 Perception, 7, 10, 11
 Personal guarantees, loans on, 121, 123, 124
 Personality, 7, 13, 14
 Petty cash book, 60
 Profit, 16, 17, 21-23, 27, 35-40, 116
 — and loss account, 16, 17, 48-55
 Prospectus, 14, 154
 Prudent (*ultra*), policies in business, 155, 156
 Public examination of persons in fraud cases, 91, 92
 — Health Act, 1875, 94
 — Prosecutor, 92
 — Trustee Act, 1906, 128-137
 — Rules, 1912, 129-131
 Purchase of a business, 2, 19-33
 Purchases, 23, 35

QUALIFICATIONS of investigating accountant, 7, 8
 Quick-thinking, 7, 11

RAILWAY, fraud on, 76-78
 Rate books, 14
 — limits of local authorities, 152
 Reasons for investigation, 64
 Register of bills of sale, 125, 154
 — of business names, 14, 154
 — of companies, 14, 83, 120, 121, 124, 125, 154
 — of land charges, 125, 154
 Removal expenses, 98
 Rent, 52, 53, 148, 149
 Rents, 133
 Re-organization, investigation as to, 3, 41-46
 Reports, 12, 33, 43, 44, 78, 93, 114, 117, 127, 130, 135, 145-147, 157
 Reserve fund, 142, 152, 153
 Reserves, 53, 152, 153
 Return of goods, 61

- Revenue account, 16, 17, 22, 23, 152
 Reversions, loans on, 121, 123
 Rural district councils, 94
- SALE of a business, 2, 47-55
 Sales, 22, 23, 61, 62, 157
 Scope of an investigation, 3-6
 Scrap materials, 157
 Scrutinizing records, 35, 36
 Self-possession, 7, 10
 Servants, frauds by, 66, 67
 —, old and trusted, 63, 64
 Severance, compensation for, 40
 Shareholders' committee, investigation for, 3, 126, 127
 Shares, ordinary, 117-119
 —, preference, 119
 Share transfer frauds, 76, 78, 157
 Sinking fund, 142
 Solvency, investigation as to, 3, 34, 35
 Somerset House files, 83
 Stability, financial, investigation as to, 3, 34, 35
 Starting point of an investigation, 14, 15, 19, 20
 Statistics, 152
 Stocks (shares), 122
 — and stocktaking, 21, 50, 51, 58, 72-74, 88, 89, 152, 157
- Stock, valuation of, 21, 23-25, 50, 51, 72-74, 88, 89, 98, 157
 Sub-contractors, 111, 112
 Surveying the position, 20
- TACT, 7-9
 "Teeming and lading," 59
 Town councils, 94
 Transfer (share) frauds, 76-78
 Transport undertaking, 16
 Treasury bills, 71
 Trust accounts, 3, 128-137
 Trusted servants, frauds by, 63, 64
 Trustee, investigation for, 3, 128-137
- ULTRA prudent policies in business, 155, 156
 Urban district councils, 94
- VOTING, powers of directors and shareholders, 117-121
- WAGES, fluctuations in, 106-108
 War bonds, 71
 Winding-up of companies, 79-93, 135
 Window dressing, 71, 72, 74
 Wright, Whitaker, fraud by, 74, 89-91

